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SUPREME COURT, U. S.
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IN THE

Supreme Court of the United States

OCTOBER TERM, 1972

No. 72- 72-523

PLANTATION PATTERNS, INCORPORATED, *Petitioner*

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*

JOHN S. JEMISON, JR., AND MARIE S. JEMISON, *Petitioners*

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*

PETITION FOR A WRIT OF CERTIORARI TO THE COURT OF APPEALS FOR THE FIFTH CIRCUIT

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OPINIONS BELOW

The opinion of the Court of Appeals is not yet officially reported. It is unofficially reported at 29 AFTR 2d ¶ 72-679, p. 72-1408, and at 72-2 USTC ¶ 9494.

The findings and opinion of the United States Tax Court (the "Tax Court"), are not officially reported,

but are incorporated in a memorandum opinion, which is given the designation TC Memo 1970-182. They are unofficially reported at 29 TCM 817 and at 39 P-H Memo TC ¶ 70,182, p. 70-899.

The date of the judgment sought to be reviewed and the time of its entry was June 15, 1972. A petition for rehearing was timely filed and was denied on July 6, 1972. The statutory provision believed to confer on this Court jurisdiction to review the judgment in question by writ of certiorari is Title 28 Sec. 1254(1) U.S. Code (62 Stat. 928).

QUESTIONS PRESENTED

1. Whether unsubordinated purchase money notes issued by a corporation to persons who had no other interest therein should be treated as debt for the income tax purposes of the corporation and the guarantor of the notes, who was the constructive owner of its common stock, where the net assets available for the payment of such purchase money notes exceeded all of the unsubordinated debts of the corporation?

2. Whether purchase money notes issued by a corporation to persons who had no other interest therein, which were guaranteed by the constructive owner of its common stock and were subordinated to general creditors and to the unsubordinated purchase money notes, should be treated as debt for income tax purposes, when the amount thereof was not more than about four times the amount of common stock and the principal of debt subordinated thereto?

3. Whether an individual who is the substantial owner of the stock of a corporation, both of whom guarantee purchase money notes issued by another

corporation, is entitled to contribution from the corporate guarantor in determining the amount which shall be treated as a dividend to the individual guarantor?

STATUTES INVOLVED

The federal statutes involved in this case are copied in the appendices, pp. 25a-26a. All are parts of the United States Internal Revenue Code of 1954 (the "1954 Code"), and are Sections 163(a), 301(a) and (c)(1), 302(d), 316(a), and 317(b).

STATEMENT OF THE CASE

The facts which we believe are relevant to the questions above are stated below, based primarily on those stated in the opinion of the Court of Appeals. Most of the facts were stipulated and a substantial part thereof which are relevant to the issues is included in written documents, the authenticity of which was stipulated.

The case involves the income tax liabilities of Plantation Patterns, Inc. for its fiscal years ended September 30, 1963, 1964 and 1965 and of John S. Jemison, Jr. and his wife, Marie S. Jemison for the calendar year, 1963.

Two separate appeals to the Tax Court are involved in this petition, but they were consolidated for hearing and decision in the Tax Court and in the Court of Appeals.

Plantation Patterns, Incorporated, the corporate petitioner herein, hereafter generally called "New Plantation," is a corporation organized under the laws of Alabama under the name Plantpat, Inc. to acquire initially the stock, and thereafter the assets, of

another corporation of the same name. This is hereinafter referred to as "Old Plantation" (pp. 3a-5a).

$5,000 of the cash which was required by New Plantation to consummate the acquisition of the stock of Old Plantation and to supply additional working capital was paid in consideration of the issue of common stock to Mrs. Marie S. Jemison. $150,000 of such cash was paid to New Plantation in consideration of the issue of 6½% subordinated debentures (the "6½% debentures") to Bradford and Company, Inc., a corporation which was not otherwise related to the Jemisons or to the stockholders of Old Plantation (p. 6a).

Mrs. Jemison was the wife of John S. Jemison, Jr. ("Mr. Jemison"), and Mr. Jemison was the substantial owner of the stock of Jemison Investment Company, Inc. Mr. and Mrs. Jemison filed a joint federal income tax return for the taxable year which is here involved, and both are therefore included as petitioners.

Old Plantation was a corporation which had been engaged for several years in the manufacture of wrought iron furniture and metal office chairs. Jemison Investment Co. made an offer to Thomas E. Jernigan and other stockholders of Old Plantation for the acquisition of all of the stock of Old Plantation and the disposition of the metal chair business to its stockholders, which, after modification, was carried into effect. The consideration fixed for the acquisition of the stock of Old Plantation, excluding those parts thereof which were referable to the metal chair business, was the net figure of $709,878.33, of which amount $100,000 was paid in cash at the time of closing, and $609,878.33 was represented by 5½% serial notes (the "5½% notes"). These were payable in equal annual

installments of $50,000, beginning October 1, 1963 and continuing through October 1, 1972, with a final installment of $109,878.33 due on October 1, 1973 (p. 8a).

The first two installments of the 5½% notes, aggregating $100,000 principal amount, were not subordinated, but the remaining $509,878.33 principal amount thereof was subordinated to the payment of all of the debts of New Plantation, other than the 6½% debentures (p. 9a).

A copy of the 5½% note to Thomas E. Jernigan which is a part of the $50,000 principal amount due on October 1, 1963, is included as Appendix III. This also shows the guarantees. The subordination provisions of the 6½% debentures are included as Appendix IV, and those of the 5½% notes as Appendix V.

Forthwith after the stock of Old Plantation was acquired by New Plantation, Old Plantation was dissolved, and its assets were distributed to New Plantation. Footnote 6 to the opinion of the Court of Appeals contains findings as to the values of the assets of New Plantation which were based upon findings by the Tax Court. The Court of Appeals also stated that the consideration for the stock of Old Plantation was equal to its net worth plus $644,909.53. However, the balance sheet set forth in footnote 6 shows that the values of the assets of New Plantation included only $199,060.70 as good will and $42,463.31 for a long term lease, pp. 7a, 11a-12a.

The Tax Court included the following specific findings with respect to the payments made on the 5½% notes and the 6½% debentures:

> "During the period from October 1, 1962 to September 30, 1966, New Plantation otherwise duly

paid principal and interest as due on the 6½ percent debentures issued to Bradford and Co., Inc. and on the 5½ percent notes issued to the stockholders of Old Plantation. Said payments were made by New Plantation without recourse to any additional financing." Vol. 39, 1970 P-H Memo TC p. 70-903.

The Court of Appeals essentially adopted this finding, p. 10a. Old Plantation had been profitable during its corporate existence, and the Tax Court opinion includes the following findings with respect to the earnings thereof after all taxes and excluding income or loss of the Chair Division. These findings are not carried into the opinion of the Court of Appeals:

Year	Net Income (Loss)
1957	($ 1,096.83)
1958	7,533.75
1959	8,067.66
1960	19,737.69
1961	94,637.46
Total	$128,879.73

The earnings of Old Plantation for the nine months period ended on September 30, 1962 aggregated $92,-368.68 after provision for taxes on income.

Payment of the 5½% notes was guaranteed by both Jemison Investment Co. and Mr. Jemison. Mr. Jemison, acting through this corporation, had been very successful, and most of his net worth was represented by the value of the stock of that Company. Jemison Investment Co. was paid a fee of $15,000.00 per year for executing the guarantee, but no fee was paid to Mr. Jemison therefor. Mrs. Jemison was treated as

the nominee of her husband in respect of the acquisition of the stock and the determination of income tax liabilities. Fifty-five separate 5½% notes for each maturity and each stockholder of Old Plantation were executed by New Plantation. No principal payment on the 6½% debentures was due until 1974, p. 8a.

Upon audit of the returns of New Plantation for its fiscal years ended September 30, 1963, 1964 and 1965 and of the return of Mr. and Mrs. Jemison for 1963, the Commissioner of Internal Revenue disallowed a deduction for the interest accrued and paid by New Plantation on both the 5½% notes and 6½% debentures, and included payments of the principal of the 5½% notes due October 1, 1963, aggregating $50,000 in the taxable income of Mr. Jemison as a constructive dividend. The Commissioner also made initially other adjustments to the income of the Jemisons which were eliminated by the Tax Court and are not material to the issues presented here, pp. 10a-12a.

Following some comments made by the presiding judge of the Tax Court, the Commissioner changed his position with respect to the deduction of interest on the 6½% debentures and proposed to allow the deduction therefor. This reduced the judgment against New Plantation, and the Commissioner did not appeal from that favorable treatment. However, in the Court of Appeals, New Plantation agreed that this deduction might be disallowed if, in order to procure deductions for interest on the 5½% notes, the $150,000 principal amount of the 6½% debentures were required to be treated as "equity" in computing the debt-equity ratio. This agreement is renewed here.

Here, we use the term "equity" in the non-technical sense in which it is used in dealing with the debt-equity ratio principles, and as is done in this

case in respect of the principal of the 5½% notes. In computing the debt-equity ratio, we eliminate the three non-interest bearing notes which total $183,435.84, since they were due to be paid with the proceeds of the sale of the United Chair Division to the stockholders of Old Plantation for a like amount. This sale was consummated forthwith after the liquidation of Old Plantation, and the notes were paid when due in 1963, pp. 9a-10a.

The only payment of principal of the 5½% notes which affects the income tax liability of the Jemisons for 1963 was the payment of a total of $50,000 on October 1 of that year which was a part of the unsubordinated portion of such notes. However, the interest disallowance to New Plantation related to all of the 5½% notes.

For the purposes of one finding, the assets of New Plantation should be stated as follows:

Fair market value of assets per balance sheet in footnote 6 to opinion	$1,261,327.81
Less: assets in United Chair Division included in accounts receivable	183,435.84
Fair market value of assets retained by New Plantation	$1,077,891.97

To offset this total, the liabilities may be stated as follows:

Debts owed to general creditors	$ 313,013.64
Unsubordinated 5½% notes	100,000.00
Partially subordinated 5½% notes	509,878.33
Fully subordinated 6½% debentures	150,000.00
Common Stock	5,000.00
	$1,077,891.97

Thus, the $100,000 principal amount of unsubordinated 5½% notes was entitled to share equally with the other general creditors ($313,013.64) in the assets of New Plantation having a fair market value of $1,077,-891.97 and had *priority* over $659,878.33 of junior debt and $5,000 of common stock, $664,878.33 in the aggregate.

Following the Tax Court largely, the Court of Appeals includes several different statements about the debt-equity ratio. One is of the import that New Plantation had tangible assets at fair market value of approximately $1,064,000 securing "debts" of approximately $1,078,000, p. 21a. The calculation of the latter amount is shown above. It includes $5,-000 of common stock, an obvious mathematical error. The reduction of the asset account by $14,000 below the liabilities account is not explained by either court and the petitioners have not found the reason therefor.

Immediately preceding the foregoing statement, the Court of Appeals states that New Plantation's "quick assets (cash and accounts receivables)" of $317,000 could not cover its current liabilities of approximately $490,000. These amounts include the $183,435.84 agreed to be paid for the United Chair Division as accounts receivable and a like amount of part of the current liabilities. The comparison between "quick assets" and current liabilities is a harsh one and ignores the fact that the fair market value of inventories was found to be $228,376.12 in said footnote 6. The omission of the inventories from the comparison is material in respect of the reference to the Tax Court finding that the assets of New Plantation vis a vis its debts were insufficient to give New Plantation "viable independence as a corporation." Actually, New Plan-

tation acquired all the assets which had enabled Old Plantation to make over $90,000 per year in the wrought iron furniture business, pp. 11a, 21a.

REASONS FOR GRANTING THE WRIT

1. **1. In holding that the debt-equity ratio was too high in respect of the $50,000 principal amount of 5½% notes that was due and paid on October 1, 1963, the decision of the Court of Appeals on an important question of Federal law is in direct and irreconcilable conflict with the decision of the Court of Appeals for the Second Circuit in Kraft Foods Co. v. Commissioner, 232 F.2d 118, the decision of the Court of Appeals for the Ninth Circuit in Murphy Logging Co. v. United States, 378 F.2d 222, and cases in the Tax Court.**

This is believed to be a case of first impression in this Court in that it does not involve the question of the payment of interest on advances or loans by stockholders to their corporation, but the consequences of a guarantee by a constructive stockholder of the indebtedness of the corporation to unrelated third parties. The Court of Appeals assumed, without stating reasons therefor, that this case involves the so-called debt-equity ratio principle, and initially we deal with the case on that basis.

The $50,000 principal amount of 5½% notes that matured on October 1, 1963, is the only part thereof which is involved in the case of the Jemisons. However, in stating the debt-equity ratio, we recognize that account must be taken of the entire $100,000 principal amount of unsubordinated 5½% notes. The fact that separate notes were given for this maturity and that of October 1, 1964 eliminates any justification for agglomerating them with the subordinated portion of the notes, although this appears to be the only theory on which the Court of Appeals proceeded in dealing with the subordinated 5½% notes, cf., *St.*

Louis Union Trust Co. v. *Champion Shoe Machinery Co.*, 109 F.2d 313 at 316 (8th Cir., 1940), pp. 5, 7 herein and pp. 8a, 9a in the Appendices.

If, as we undertake to demonstrate under reason 2, effect is to be given to the consensual subordinations of some of the 5½% notes and of the 6½% debentures, the debt-equity ratios are very different from those which are stated in the opinions of the courts below. In the case of the unsubordinated 5½% notes, the equity, including the $659,878.33 of debts which were subordinated thereto, was initially $664,878.33, not the $5,000.00 mentioned in the opinion of the Court of Appeals. Normally, in stating the debt-equity ratios, only long-term debt is considered, and the Court of Appeals generally treated it that way.

This would then be only $100,000, and the ratio would then be 1 to 6.6. Even if liabilities to other general creditors were added, making it $413,013.64, the ratio would be 4.1 to 6.6, or about 2 to 3.

In *Kraft Foods Co.* v. *Commissioner*, 232 F.2d 118 (2nd Cir., 1956), the debt was $30,000,000 and the equity was $39,000,000, a ratio of 10 to 13. The Court there held there was no "thin capitalization." The ratio in *Murphy Logging Co.* v. *United States*, 378 F.2d 222 (9th Cir., 1967), is not made clear, but certainly the equity did not exceed the debt. In fact, there is no case of which we are aware in which a corporation has been held to be thinly capitalized in which the equity exceeded the debt, and we believe there is none which is referable solely to the debt-equity ratio. No guarantee was involved in *Kraft Foods*, but in *Murphy Logging*, the stockholders did guarantee the debt in question. The conflicts here noted should, we

submit, influence the Court to grant the writ, and reverse the Court of Appeals.

To the extent to which *John Kelley Company* v. *Commissioner,* 326 U.S. 521 (1946) is authoritative at all since it applied the rule of *Dobson* v. *Commissioner,* 320 U.S. 489 (1943), it corresponds with *Kraft Foods Company,* in that the equity exceeded the debt substantially.

This should dispose of the case for the Jemisons. But no interest on any of the 5½% notes was allowed as a deduction. So, the status of the subordinated notes must be also dealt with. Here, the direct conflict is with *Murphy Logging* alone, though this extends to the valuation question also.

The debt-equity ratio, as generally computed, is slightly less than 4 to 1 in the case of the subordinated 5½% notes—$609,878.33 of debt to $155,000.00 of equity—including, as equity, the principal amount of the 6½% debentures. Neither the Tax Court nor the Court of Appeals treated the case as involving such a ratio, erroneous as was this failure. The presiding judge of the Tax Court intimated that if the 6½% debentures were treated as equity, New Plantation was not thinly capitalized. As we read the opinion, the Court of Appeals agreed:

> ". . . If these notes are regarded as equity, taxpayers argue that the debt-equity ratio of New Plantation would be approximately 4 to 1 ($609,878.33 to $155,000), and not the plus 125 to 1 ratio which the government asserts is the proper debt-equity ratio ($759,878.33 to $5,000). *This would effectively demolish the Tax Court finding of thin capitalization.*" (emphasis supplied, p. 18a)

That we correctly interpret the last sentence is indicated by the fact that the 6½% debentures were

treated as debt in arriving at a ratio of 150 to 1—$759,878.33 to $5,000 (erroneously stated to be 125 to 1). The Court of Appeals really accepted this position, since the holding that the debentures evidenced a loan was affirmed (pp. 18a, 23a).

For a case in which the Tax Court first determined that certain stockholder loans were equity and then concluded that certain other debt guaranteed by stockholders was debt because, after treating the stockholder loans as equity, the corporation was not thinly capitalized, see *J. Paul Smyers,* 57 T.C. 128 (1971).

Differences about the proper debt-equity are not the only conflicts between the decision of the Court of Appeals below and those in *Murphy Logging* and *Kraft Foods.* They are also opposed in the approaches toward valuation of businesses and the significance of prior earning power and established businesses. In this area, the opinion expressly concedes conflict with the Ninth Circuit in *Murphy Logging,* pp. 22a, 23a.

In substance, the Court of Appeals says that no value is to be assigned to "management skills and normal business contacts," since they are expected of "management in the direction of any corporation," p. 23a. But not every management has them in adequate degree, or there would be no, or fewer, insolvencies and unsuccessful business enterprises. The ability of stockholders to procure profitable contracts was the predicate for the conclusion on valuation in *Murphy Logging.* This gave assurance of future earning power (based on past experience) which would enable that corporation to function.

Recognition of going concern value is general, if not universal, in the business community. It was given

effect in *Kraft Foods* in the statement that earning power demonstrated in prior years, assured debt service (232 F.2d 122). In this case, the Court of Appeals rejects later success as a significant factor. But the record and findings of the Tax Court also show prior earnings that would give some assurance of continued profitable operations sufficient to service the debts actually assumed, as they fell due. This was a fact that was known at the inception of the business and no doubt influenced the decision of knowledgeable investors involved to pay the agreed price in an arm's length transaction. The facts about earnings are stated on p. 6.

Here, we call attention to them to show the conflicts. The conclusion of the Court of Appeals on this question is also in direct conflict with the decisions of the Tax Court in *Baker Commodities, Inc.,* 48 T.C. 374 at 397 (1967), and in *George A. Nye,* 50 T.C. 203 at 215 (1968). This Court held that subsequent events were proper evidence in this area in *Sinclair Refining Co.* v. *Jenkins Petroleum Process Co.,* 289 U.S. 689 at 697 (1933).

Ainslie Perrault, 25 T.C. 439 at 450-1 (1955), is especially significant because of the Commissioner's acquiescence therein (1956-1 Cum. Bul. 5).

In ultimate reliance on *Sinclair Refining Co.,* the first two Tax Court cases take account of later earnings in appraising going concern value. So do *Nachod & U.S. Signal Co.* v. *Helvering,* 74 F.2d 164, 168 (6th Cir., 1934) and *Tex-Penn Oil Co.* v. *Commissioner,* 83 F.2d 518 (3rd Cir., 1936) in other phases of the income tax law. Taxable income of New Plantation for its fiscal years 1963, 1964 and 1965 is in evidence as a

part of the government's case to fix the deficiencies, and proof of payment of the 1963 installment of 5½% notes is the predicate for the deficiency assessed against the Jemisons. Both the Tax Court and the Court of Appeals expressly found that all obligations on the 5½% notes and the 6½% debentures had been met through September 30, 1966, without recourse to additional financing. The amounts of interest involved are also stated (p. 10a).

Nevertheless, in spite of this finding and the conflict with the foregoing authorities, the Court of Appeals said it did not regard as significant the fact that ultimately things progressed smoothly, and that New Plantation met its obligations. The reason assigned was that the issue was whether "at its inception" there was a reasonable prospect that "the business would succeed on its own" (p. 22a). We do not see how, in the face of the foregoing authorities, the Court of Appeals could, in the valuation area, and in the determination whether New Plantation would have "viable independence as a corporation," (p. 18a) refuse to attribute significance to facts that are inherently a part of the record for other purposes.

In *Kraft Foods,* the Court stated that earnings continued to be good in the taxable years at issue, but does not indicate what effect, if any, was given thereto (232 F.2d 121). But there was certainly reliance on past earnings (232 F.2d 122).

As a matter of fact, it is almost inescapable that in finding that the 6½% debentures constituted a true loan, both courts below were substantially influenced by the fact that New Plantation paid the interest on and principal of the 5½% notes and the 6½% debentures as they matured. In numerous instances, the

courts take cognizance of extensions of payment and other indulgences in finding that advances by stockholders to their corporation constitute equity rather than debt. On the other hand, compliance with the requirements of the controlling documents support the treatment as debt, e.g., *Harlan* v. *U.S.*, 409 F.2d 904 (5th Cir., 1969).

While relying on the authority of the foregoing cases as to the materiality of subsequent earnings and debt history, we also meet the Court of Appeals on its own grounds, and show that its ultimate findings are in conflict not only with *Kraft Foods, Murphy Logging,* and the Tax Court cases just cited, but also with decisions of this Court. After a short life, Old Plantation had realized earnings, net after taxes, of $94,637.46 in 1961 and $92,368.68 in the first nine months of 1962. Even after taking account of additional interest and depreciation charges, these were sufficient to service the 5½% notes and 6½% debentures. See p. 10a.

The Tax Court cases involved obligations of a corporation to its stockholders, and so are direct authorities essentially in line with *Kraft Foods.* They are also debt-equity cases in which going-concern value was considered, as in *Murphy Logging.*

The predicates for the express refusal of the Court of Appeals to follow *Murphy Logging* and the objections thereto by the Tax Court and the Commissioner, noted on pp. 17a and 19a, are directed at the business contacts and financial skills of Mr. Jemison, and do not take account of the demonstrated earning power of the business which was acquired by New Plantation from Old Plantation. The expectancy of "future custom" (as it is in *Murphy Logging*), as well as competency

of management, was an asset vested in New Plantation, as indicated by past earning power. If continued, this was sufficient to assure service of the purchase money debt assumed by New Plantation.

The failure of the Court of Appeals to take account of the value of earning power does not accord with decisions of this Court in numerous cases, of which we cite only two, *Commissioner* v. *Clay B. Brown*, 380 U.S. 563 (1965) and *Protective Committee for Independent Stockholders of TMT Trailer Ferry, Inc.* v. *Anderson*, 390 U.S. 414 (1968). In *Clay B. Brown*, this Court sustained a transaction as a sale at a large price over book value because it was indicated that prospective earnings would be sufficient to pay the sale price. The government abandoned a contention that the transaction was a sham. 380 U.S. at 569. This is pertinent here on another point, p. 40.

In *TMT Trailer Ferry, Inc.*, this Court restated the principle that, in reorganizations under the Bankruptcy Act, an estimate must be made of prospective earning power and held further that the determination thereof need not be based on past earning power alone. Indeed, the reversal was based largely on the trial court's failure to give effect to factors that indicated that earning power in the future might be better than in the past. (390 U.S. at 452 and 453)

This case involved implicit applications of the principles that a lower court should be reversed if it does not apply proper standards to the facts or if it fails to take adequate account of all the evidence, and especially findings, that should be considered in arriving at a proper judgment. *United States* v. *Parke, Davis & Co.*, 362 U.S. 29, 44 (1960) asserts the first principle. *New York Central & H.R.R. Co.* v. *Beaham*,

242 U.S. 148 (1916), holds that a court may not arbitrarily disregard evidence.

This is also implicit in *Helvering* v. *Tex-Penn Oil Co.*, 300 U.S. 481 at 491 (1937). There, as in other cases, this Court also uses express findings of "primary" facts by the trial court in arriving at its conclusions of "ultimate" facts. The facts stated by the Court of Appeals here adequately show the pertinent subordinations and the fact that the notes and the debentures were serviced (pp. 6a, 9a and 10a).

Proper consideration of going-concern value supplies part of the answer to the statement that only "$5,000 was set up as equity to finance launching of the corporate venture" (p. 20a), and the repetition of the Tax Court finding that the corporate assets were wholly inadequate to sustain a debt of $609,878.33, p. 19a. These overlook or ignore the fact that an active business was continued under new ownership, as well as the function of the $150,000 of cash supplied by the holders of the subordinated 6½% debentures.

The Court of Appeals repeats this error in the next paragraph on p. 20a dealing with "other supposed equity-factors" in a reference to the claimed "meager capital position" of New Plantation. We urge that these failures to give proper consideration to the undisputed evidence about earning power and the significance of subordinated "capital" require reversal, *New York C. & H. R. R. Co.* v. *Beaham*, and *U.S.* v. *Parke, Davis & Company*.

We do not mean to exclude the possibility that the business might not have been sufficient to service the 6½% debentures. However, in the event of a default thereon, the holders might acquire the business, but

this would not adversely affect the ability of New Plantation to meet all of its obligations on the 5½% notes.

2. In failing to give effect to the consensual subordinations of $509,878.33 principle amount of the 5½% notes and $150,000 principal amount of the 6½% debentures in determining the applicable debt-equity ratios, the decision of the Court of Appeals is in conflict with the decision of the Court of Appeals for the Second Circuit in the case of In re Credit Industrial Corporation, 366 F.2d 402, with decisions in five other circuits, and with United States v. Key, 397 U.S. 322 (1970).

In this case, we are, in fact, concerned with three debt-equity ratios, (1) with respect to the $100,000 principal amount of 5½% notes that were unsubordinated, (2) with respect to the $509,878.33 subordinated 5½% notes, and (3) with respect to the 6½% debentures. While each is obviously different in determining whether or not there is thin capitalization, the Court of Appeals did not recognize that there was any difference in comparing debts of approximately $1,078,000 with assets of $1,064,000 "at fair market value," p. 21a.

The derivation of these figures is shown above, p. 8.

It is implicit in the opinions of both lower courts that the debt-equity ratio is only relevant in determining whether, after taking account of the claims of other creditors, there is a reasonable prospect that the debt in question can be paid. This requires a comparison of asset values with such debt and other debts having the right to participate in those assets. Since, by express provision therein, the 6½% debentures were subordinated to all other debts, they are to be excluded from the debts that are to be compared with the 5½% notes (App. IV, p. 6a).

The reasons for execution of such subordination agreements which are relevant here and support the foregoing contention are well stated in the opinion in *Austin* v. *National Discount Corporation*, 322 F.2d 928 (4th Cir., 1963). After stating that lending banks in deciding what amount they will lend, relied to a large extent on the amount of "capital" and that, in determining such amount, these banks include subordinated long-term indebtedness, the Court proceeds:

> "This is based on the realization that the sale of such subordinated debt, as does the sale of capital stock, swells the amount of assets of the finance company available for operating use without increasing the amount of debt that will share the available assets on a parity with the banks in the event of bankruptcy." (322 F.2d 929)

Furthermore, in the case of the $50,000 of 5½% notes that were due and paid on each of October 1, 1963 and 1964, the remaining $509,878.33 principal amount of such notes that was subordinated to such $100,000 should be excluded.

The Tax Court and the Court of Appeals refused, or failed, to give effect to these provisions for consensual subordination in several respects in treating the debts as $1,078,000, namely: (1) in stating that the assets were wholly inadequate to sustain a debt of $609,878.33 rather than just $100,000, as to the unsubordinated portion; (2) in stating that only $5,000 was set up as equity; and (3) in holding that the $150,000 principal amount of 6½% debentures was debt though subordinated to all the 5½% notes (pp. 19a, 20a, 21a, 23a).

In failing to give effect to such consensual subordination agreements, the decision of the Court of Ap-

peals is in irreconcilable conflict with the decision of the Court of Appeals for the Second Circuit in the case of *In re Credit Industrial Corp.*, 366 F.2d 402, 408-9 (2nd Cir., 1966), and other authorities cited in Calligar "Subordination Agreements," 70 Yale L.J. 376-404 (1961). This article demonstrates the usefulness of the subordination device in corporate financing. See also *Collier on Bankruptcy* § 65.06. The other authorities, most of which are cited in the Calligar article, include the following decisions of five Courts of Appeal:

St. Louis Union Trust Co. v. *Champion Shoe Mach. Co.*, already cited, a decision of the 8th Circuit

Bank of America National Trust & Savings Asso. v. *Erickson*, 117 F.2d 796, 798 (9th Cir., 1941)

In re Dodge-Freedman Poultry Co., 148 F.Supp. 647, aff'd on opinion below, 244 F.2d 314 (1st Cir., 1957)

Austin v. *National Discount Corp.*, just cited

In re George C. Bruns Co., 256 Fed. 840, 841 (7th Cir., 1919)

United States v. *Key*, 397 U.S. 322, 327 (1970) is in essential accord with those decisions of the Courts of Appeal. It is discussed on pages 26 and 33.

Indeed, it is entirely anomalous to treat the 6½% debentures as debt though subordinated to the 5½% notes and in treating those notes as involving a contribution to capital. This inconsistency in the decision of the Tax Court should have been alone enough to require reversal by the Court of Appeals. The perpetuation of it should be sufficient to require reversal of the Court of Appeals by this Court. To that extent, the two judgments are arbitrary and without rational foundation and are therefore not entitled to the bene-

fit of a presumption in their favor. This Court has so held in the case of conclusions by the Commissioner. *Helvering* v. *Taylor,* 293 U.S. 507 (1935). See also *The Lottawanna,* also styled *Wilson* v. *Bell,* 20 Wall. (87 U.S.) 201, 217 (1874) and further discussion in the argument, pp. 32-5.

In dealing with the status of the 6½% debentures, the Court of Appeals said that subordination is far from the "sole criterion" for determining whether an interest is debt or equity. This purported answer is merely begging the question, for it is the status of the 5½% notes which is at issue, not that of the 6½% debentures. Subordination alone prevents the holders of the 6½% debentures from participating with holders of the 5½% notes in assets of New Plantation. Therefore, in ascertaining the debt-equity ratio for the 5½% notes, in determining the deductibility of interest thereon, it is immaterial whether the debentures are treated as debt or equity. See *Austin* v. *National Discount Corp.* where cited on p. 20.

3. The decision of the Court of Appeals in this case is in conflict with the decision of the Court of Appeals for the Ninth Circuit in Murphy Logging Company v. United States, 378 F.2d 222 (1967), and with the decisions of the United States Tax Court in Arthur J. Kobacker, 37 T.C. 882 (1962), and Santa Anita Consolidated, Inc., 50 T.C. 536 (1968), on an important question of federal income tax law in treating the 5½% notes issued by the New Plantation as equity for income tax purposes because they were guaranteed by Mr. Jemison, the constructive owner of New Plantation's common stock, just as the owners in Murphy Logging had guaranteed such debts.

For various reasons, including the effects of a total recasting of the transaction, the Court of Appeals did not undertake to justify its treatment of a guarantee in the same way that it treats direct advances by

stockholders to the corporation. Yet, there are important differences between the relationship of a direct creditor of a corporation and a guarantor of its indebtedness to a third person. In the case of a direct creditor, he receives amounts paid as interest and as principal.

In the case of a guarantee, the payments to the principal debtor merely reduce the exposure of the guarantor to the necessity for payment of the debt if the principal debtor defaults in such payment. The guarantor is only contingently liable and does not receive any property or money to constitute income. This Court has, we believe, never passed on this question and in *Murphy Logging,* the government conceded that it was probably the first of its kind. There is no decision like those of the courts below, except that of the trial court in *Murphy Logging.*

A guarantee creates different relationships and obligations from those of a direct advance. In this case, the guarantors would not be liable to other general creditors of New Plantation, who held some $313,500 of debt, and they would participate with them, on subrogation principles, if required to pay the unsubordinated notes. Section 87 of Title 9 of the Code of Alabama of 1940.[1] The Tax Court treated Mr. Jemison as the primary obligor with respect to the 5½% notes, stating that the guarantee was an indirect contribution of capital. The Court of Appeals states that Mr. Jemison's guarantee was "an obligation primary

[1] Sec. 87 of Tit. 9 reads:

"§ 87. Subrogation.—A surety who has paid the debt of his principal is subrogated both at law and in equity, to all the rights of the creditor, and in a controversy with other creditors, and in a controversy with other creditors, ranks in dignity the same as the creditor whose claim is paid."

in nature" (pp. 12a, 19a). In *Murphy Logging Company,* the Court of Appeals for the Ninth Circuit declined to recast or, as it says, "collapse" the transaction. The argument contains comment on the "indirect contribution of capital" (p. 42).

To treat Mr. Jemison as the primary obligor means that he was the purchaser of the stock of Old Plantation and contributed that stock to New Plantation. In that case, the liquidation of Old Plantation would not give the benefit of § 334(b)(2) of the 1954 Code to New Plantation. § 334(b)(3)(C) of the 1954 Code. The Tax Court was inconsistent in giving New Plantation basis related to the purchase price and in calling Mr. Jemison the purchaser.

Guarantee of corporate debts by stockholders is a common practice and is commonly required in the case of closely held corporations. This is expressly recognized in the opinion of the Tax Court (¶ 70, 182, 39 P-H Memo TC p. 910-70). There are reasons for requiring a guarantee aside from the credit factor.

Businessmen and bankers are very much interested in knowing whether, in the case of a guarantee by a stockholder, payments by a corporate debtor of interest and principal are to be treated, for income tax purposes, differently from the intention of the parties, irrespective of intention, where it is plain that the corporation involved is the principal debtor. It would greatly disturb banking relationships and impair the borrowing power of small corporate businesses if the execution of a guarantee by its stockholders is to have the double taxation effects which are imposed in the cases at bar.

Insofar as recasting the transaction is concerned, other parties than the corporation and guarantor are

involved. Here, the stockholders of Old Plantation were given claims against New Plantation, as principal debtor, and it is quite clear that they had no intention of releasing those claims in reliance solely upon the guarantee. So, where the creditor looks to both the named principal debtor and the named guarantor, the business community needs to know whether the form of the transaction is always to be disregarded, or, if not, then in what situations that is to be the case. If so-called thin capitalization is to influence the ultimate conclusion, we submit that it should be made known authoritatively. In the present state of the decisions on the subject, only this Court can speak with the necessary finality.

4. In failing to assign a separate classification to the unsubordinated 5½% notes, the decision of the Court of Appeals is in essential conflict with the decision of the Court of Appeals for the Eighth Circuit in St. Louis Union Trust Company v. Champion Shoe Machinery Company, 109 F.2d 313 (1940) and with the decision of this Court in United States v. Key, 397 U.S. 322 (1970).

The decision in *St. Louis Union Trust Company* is cited above in support of the contention that the unsubordinated 5½% notes should not be agglomerated with the subordinated 5½% notes in determining the debt-equity ratio. That case involved bonds which had specific maturities. In connection with extensions of those maturities, some of the holders of the bonds also agreed that they should be subordinated to other debts of the corporate debtor. It was held that the bonds which were not subordinated reserved rights sufficiently distinct to entitle them to separate classification in the distribution of the assets of the bankrupt debtor. The Court said:

> "We think that the appellants' rights were sufficiently distinct from those of other bondholders

to entitle the appellants and those who were similarly situated to a separate classification." 109 F.2d 316.

The Court of Appeals recognized that $100,000 principal amount of the 5½% notes were unsubordinated, but did not treat the subordinated 5½% notes as the equivalent of capital in the determination of any debt-equity ratio. This is in addition to the failure to treat the 6½% debentures as equity in that determination. Under *St. Louis Union Trust Company,* as well as other cases, it is clear that, in the event of bankruptcy, the subordination agreements would be given effect. Therefore, the decision of the Court of Appeals is in irreconcilable conflict with the Eighth Circuit on this point.

St. Louis Union Trust Co. and others of like import which are cited on p. 21 apply equitable principles to the distribution of assets in bankruptcy proceedings. This is in accord with significant decisions in this Court concerning reorganizations, both in receiverships and in proceedings under the Bankruptcy Act. The original cases dealt with the need for preferring creditors over stockholders, and secured creditors over general creditors under general principles or a statute which specified that the plan of reorganization must be "fair and equitable."

However, there is a case which did not involve secured creditors, but the United States, which was held to have a statutory priority in the distribution of the assets of a bankrupt estate. In *United States* v. *Key,* this Court held that a plan of reorganization which did not give full effect to that priority, treating it, in substance, as constituting a separate class, would not be

permitted, and that the plan must be reframed to accord the United States its full priority rights.

In failing to treat the holders of the 5½% unsubordinated notes as constituting a separate class, entitled to full priority over debt subordinated thereto, as well as stock, the Court of Appeals rendered a decision that is wholly irreconcilable with *United States* v. *Key*.

5. In undertaking to recast the transaction so as to impose on Mr. Jemison supposedly the primary obligation for the payment of the 5½% notes, the decision of the Court of Appeals ignores economic realities and the express provisions of unimpeached documents in such manner as to conflict, essentially, with the principles that are applicable in disregarding the form of a transaction which are declared and applied in cases like the decision of the Court of Appeals for the Third Circuit in Tex-Penn Oil Company v. Commissioner, 83 F.2d 518 (1936), and decisions of this Court in Helvering v. Tex-Penn Oil Company, 300 U.S. 481 (1937), and U.S. v. Cumberland Public Service Co., 338 U.S. 451 (1950).

Unlike cases involving advances or sales to a corporation by one or more of its stockholders, the guarantee situation involves the rights of third parties which not only cannot be disregarded but which require some consideration for their interests in undertaking to establish that the substance of the transaction differs from its form. In this case, the Court of Appeals and the Tax Court necessarily recognized that the sellers of the stock of Old Plantation intended to and did receive obligations of New Plantation which were payable in all events, at fixed times over a term of years, with an established rate of interest and contained other attributes which are common in the case of debts, but did not reserve to the holders any right to vote or participate in management or contain any other attributes of stock, unless partial subordination

of a portion of the 5½% notes be deemed such a deviation from the characteristics of an instrument purporting to create a debt.

This was expressly recognized in the opinion in the Tax Court which conceded that the 5½% notes were "entirely conventional in form rather than hybrid securities, with some of the characteristics of an equity issue . . ." (¶ 70,182 P-H Memo TC, pp. 908-70). The opinion of the Court of Appeals is not so specific, but there is a clear recognition of the right of Old Plantation stockholders to collect the 5½% notes that were given to them, possibly most distinctly in the description of Mr. Jemison's guarantee as "an obligation primary in nature." (p. 20a)

If we should concede the right to recast the transaction to any extent whatever, the Courts should surely be guided by economic realities and by what was done, and not be permitted to ignore those aspects of the transaction in order to increase the total tax liabilities of all parties to the United States, irrespective of the true nature of the transaction.

The preference of Mr. Jemison as the primary obligor in lieu of Jemison Investment Company completely ignores economic realities in the circumstances of this case. The Tax Court found, and the Court of Appeals incorporated that finding in the statement that it was uncontested that "practically all of Mr. Jemison's assets consisted of stock in Jemison Investment Company." (p. 24a). In those circumstances, a direct obligation of a corporation is undoubtedly of greater value than that of a stockholder who would meet his obligations on a guarantee by receipt of dividends from that corporation.

In addition, Jemison Investment Company received a fee of $15,000. This reason for finding that it should be the primary obligor rather than Mr. Jemison is disregarded, because it is said that Mr. Jemison could control what was done and on a statement that the guarantee was either a matter of internal accounting or for cosmetic effect. The assignment of those reasons for disregarding a conceded fact and for stating that it did not supply an indication that the sellers of Old Plantation "realistically looked to Jemison Investment Company for any security" ignores any effect of that fee upon the holder of the 6½% debentures.

In any event, to find that the holders of the guaranteed obligations did not look to the financially stronger of the two guarantors carries the doctrine of looking to substance rather than form to extremes that are wholly inconsistent with the authorities which deal with that question. There is no justification whatever for concluding that the guarantee by Jemison Investment Company was a sham. Rather, it is proper to infer that the guarantee of Mr. Jemison was added to that of the Investment Company, because it is normal to expect guarantees of obligations incurred by closely held corporations. The conclusion to disregard the Jemison Investment Company guarantee is inconsistent with the recognition of that common business practice which was recognized in the opinion of the Tax Court itself, 39 P-H Memo TC ¶ 70,182, p. 70-910.

6. In failing to find that Mr. Jemison was entitled to contribution from Jemison Investment Company in respect of any payment that he might make pursuant to his guarantee of the 5½% notes, the decision of the Court of Appeals is in direct conflict with the decision in Phillips-Jones Corporation v. Parmley, 302 U.S. 233 (1937).

Even if the Court should not be satisfied that Jemison Investment Company was the primary obligor on the guarantees, it was certainly obligated jointly with Mr. Jemison and therefore would be required to respond equally with him. The basic principle arises under general law and was applied in *Phillips-Jones Corporation* v. *Parmley*, 302 U.S. 233 (1937). It is there said that, in an action for contribution, the plaintiff must prove that there was a common burden of debt (here based on guarantees by two different guarantors) and that he has as between himself and the defendants paid more than his fair share of the common obligations. The case involved the rights of a transferee from whom the entire tax was collected to contribution from the other stockholder transferees. The opinion of this Court includes the following sentence:

> "The injustice of allowing the other stockholders to escape contribution is obvious." (302 U.S. 235)

The common law on this subject is carried into Sec. 85 of Title 9 of the Code of Alabama of 1940 which, as amended, reads:

> § 85. Contribution.—All the foregoing provisions shall apply to cases where there are more than one surety, so as to enable a surety discharging a joint debt, in whole or in part, either pending the action or after joint or several judgments, to control the same against his cosureties for the purpose of compelling them to contribute their respective shares of the amount so paid by him."

Under this statute and the underlying law declared in *Phillips-Jones Corporation*, Jemison Investment Company is the primary obligor with respect to at least one-half of any payment which would be required under the guarantees. It is inappropriate and unjust to treat relief from the burden of paying that one-half as a constructive dividend to Mr. Jemison. Although we raised this question, the Court of Appeals did not even state the issue.

ARGUMENT

The Inconsistency in Treatment of the 6½% Subordinated Debentures and the 5½% Notes by the Courts Below in a Case of First Impression Requires Reversal.

So far as the petitioners know, the decisions below are the first cases in which a guarantor has been held to receive constructive dividend income upon payments to the creditor by the principal debtor, at the appellate level. A decision of that import by the trial court was reversed in *Murphy Logging Company*, and that is the only case at the appellate level of which we are aware. Several decisions in the Tax Court support the positions of the petitioners herein. They include *Arthur J. Kobacker, Santa Anita Consolidated, Inc.* and *J. Paul Smyers*.

The number of business transactions which might be affected by decisions of the import of that of the Court of Appeals in this case is truly incalculable, because so often loans to corporations, especially relatively small corporations, are required to be guaranteed by one or more stockholders. This guarantee is not necessarily supplied for credit reasons but often merely to forestall dissipation of the corporation's assets.

It is, therefore, important that this Court establish a basic policy which would not only resolve the conflict

between the Fifth Circuit, on the one hand, and the Ninth Circuit and the Tax Court on the other, but would also inform creditors and stockholders whether they may expect double taxation when a guarantee is required and given in all cases, or even in a limited number thereof. Furthermore, there is a wide range of views about what is a proper debt-equity ratio. The business community needs to know what may be expected in this area.

We feel free to speak of this case as one of first impression in this Court, as *John Kelley Co.* did not involve a guarantor and was decided under the *Dobson* rule. Insofar as it is an authority, it appears favorable as to treatment of the 5½% notes as debt. Independent of the guarantee, there seems to be no doubt that they would qualify as evidencing debt rather than stock according to the standards applied in *John Kelley Co.* The opinion of the Tax Court implicitly concedes this, and the Court of Appeals apparently concurs. (pp. 13a, 20a; 39 P-H Memo TC ¶ 70,182, p. 908-70[2])

The most striking, indeed singular, aspects of the decision of the courts below are the inconsistent dealings with the effects of subordination and the inconsistent and anomalous holding that the 6½% debentures, though subordinated to all of the 5½% notes, evidence debt, while all of the 5½% notes, though some were not subordinated to any debt, and all of them had priority over the 6½% debentures, constituted equity. We conceive this to be an altogether incredible result. Yet, it appears to be responsible for several of the

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[2] On pp. 13a and 20a, in dealing with this specific point, the Court of Appeals refers to the 5½% notes as "debentures." In other places, this is done also with some resulting confusion.

predicates on which the conclusion is based that the 5½% notes did not represent debt.

For example, the conclusion that New Plantation was thinly capitalized is based upon statements that it had tangible assets of approximately $1,064,000 securing debts of approximately $1,078,000, and that "only $5,000 was set up as equity to finance launching of the corporate venture" (pp. 21a, 20a). The $1,078,000 of debts includes the $5,000 of capital stock, and the $150,000 principal amount of the 6½% debentures.

As to the 6½% debentures, there can be no reasonable doubt that they constituted "equity" or "capital" in respect of the 5½% notes because of the provisions for consensual subordination, that are incorporated therein. App. IV, p. 32a. This is made clear by the authorities in support of Reason 2, pp. 20-1. Of these cases, *St. Louis Union Trust Company* and *Austin* v. *National Discount Corporation* contain the most useful comments. Since it is a decision of this Court, *United States* v. *Key* is the most significant authority. Surely, in determining the amount of "capital" or "equity" which is available for the payment of a particular debt, the effects of a subordination which is created by a statute giving priority to a creditor cannot differ from those of a consensual subordination.

We urge that the bankruptcy cases are relevant, since the ultimate issue is whether there was a reasonable prospect that the 5½% notes would be paid as they matured. Priorities in bankruptcy proceedings might well determine this.

The statement that only $5,000 was set up as equity to finance launching of the corporate venture is only correct in the event that one disregards the subordina-

tion of the 6½% debentures and the receipt of the $150,000 therefor. In its context, the statement is most certainly misleading and, based on the authorities cited, it is essentially incorrect, as a matter of law (p. 20a). Nevertheless, conclusions like these appear to be the reasons why the Court of Appeals never deals, in terms, with the question of what debt-equity ratio is proper in these circumstances.

This anomalous treatment is accompanied by a correspondingly inconsistent treatment of the effects of subordination. In dealing with the 5½% notes, the Court of Appeals emphasized the fact that the sellers "considered financially acceptable an agreement to subordinate the great majority of the 5½% debentures (sic) to almost all other corporate indebtedness. . . ." (p. 20a) But in the case of the 6½% debentures, the Court of Appeals says that subordination is far from the sole criterion "in determining whether an interest is debt or equity. . . ." and adds that "aside from this single factor, this record is productive of nothing to indicate that this was not a bona fide loan. . . ." (p. 23a).

However, subordination, even though it be subordination to an interest which was concurrently held to be equity, is not the only factor on which the Court of Appeals itself relied in finding that the 5½% notes did not constitute debt. Those factors, in addition to subordination to all debt, including the 5½% notes, should have influenced that Court to treat the 6½% debentures as equity. Other factors and the reasons therefor include:

(1) the finding of "thin capitalization" based on comparing assets of $1,064,000 with alleged debts of $1,078,000 (p. 21a). However, this plainly relates to the

status of the 6½% debentures rather than the 5½% notes, and contains an erroneous implication as to the proper debt-equity ratio for both the subordinated and unsubordinated 5½% notes; (2) the statement that only $5,000 was set up as equity to finance launching of the corporate venture (p. 20a). If the consensual subordination of the 6½% debentures is given effect, this is applicable only to the debentures, not to any of the 5½% notes; (3) the statement on page 20a that the substantial portion of the $609,878.33 was directed to the purchase of capital assets and to finance initial operations is certainly equally applicable in the case of the $150,000 of cash supplied to New Plantation as consideration for the 6½% debentures. Indeed, it is clear that at least $96,000 of the funds supplied thereby constituted part of the down payment to the stockholders of Old Plantation, because the New Plantation cash account was only $54,038.26 after that payment had been made, footnote 6, pp. 11a-12a; and (4) the statement of the finding that "the corporate assets of New Plantation were wholly inadequate to sustain a debt of $609,878.33." (p. 19a) Based upon the argument respecting the effect of past earnings on the going concern value of the business acquired by New Plantation, we urge that this finding is not sustainable (p. 13 ff.). But the point here is that if the assets of New Plantation "vis a vis its debts" were insufficient to sustain a debt of $609,878.33, they were certainly also insufficient to sustain a debt of $759,878.33. The latter figure includes the principal amount of the 6½% debentures. The inconsistency in dealing with the debt to be offset by assets is especially striking in view of the government's argument as to the debt-equity ratio, $759,878.33 to $5,000, instead of $609,878.33 to $155,000, which appears just before the statement of the finding

(p. 19a). That part of the opinion is copied herein on page 12.

In *Helvering* v. *Taylor*, 293 U.S. 507, at 514-5, this Court established the principle that the fact that the determination of the Commissioner is arbitrarily made, and is without rational foundation is sufficient to require the reviewing body, there the Board of Tax Appeals, to set it aside. The approach of *Taylor* should be equally applicable to the review of judgments and opinions of courts, for there cannot be any proper presumption in favor of the judgment of a court which is internally inconsistent and illogical.

The principles of *Taylor* still have vitality, and principles corresponding thereto were applied in *Bar L Ranch* v. *Phinney*, 426 F. 2d 995 (5th Cir., 1970). An even more direct authority holding that a decree must be reversed when one part is repugnant to another is *The Lottawanna*, also styled *Wilson* v. *Bell*, 20 Wallace (87 U.S.) 201, 217 (1874).

The Critical Questions in These Cases Constitute, Or Include, Questions of Law That Have Been Decided Erroneously.

The Court of Appeals erroneously proceeded upon the assumption that its review of the decision of the Tax Court was governed by Rule 52(a) of the Federal Rules of Civil Procedure and required a determination that the Tax Court's findings on the ultimate question were "clearly erroneous" before that decision could be reversed.

Generally, that rule is concerned with what are sometimes called "primary, evidentiary or circumstantial facts" not with "ultimate facts." Findings of ultimate fact tender questions of law (or mixed questions of law and fact), and the appellate court may

arrive at its own conclusions. In doing so, it may apply the primary facts found below. *Helvering* v. *Tex-Penn Oil Co.*, 300 U.S. at 491; *Kraft Foods Company*, 232 F.2d at 122, citing *Tex-Penn Oil Co.*

The error is most prejudicial in the acceptance of the finding of "thin capitalization." (p. 21a) This is surely an ultimate fact. Basic to any such finding is what constitutes "equity" or "capital" in determining the debt-equity ratio. In these cases, the most important factor is the effect of subordinations.

Furthermore, it is based on an erroneous statement of the factors that are relevant in the case of the 5½% notes in treating $1,078,000 as debt. The lower court can be reversed if it has proceeded upon an erroneous view of the law, irrespective of its findings of fact. *United States* v. *Parke Davis & Company*, 362 U.S. at 44. Nor may a court arbitrarily disregard evidence, such as the subordination of the 6½% debentures. *New York C. & H.R. Co.* v. *Beaham*. (p. 21a)

In the present case, there is no dispute about the material facts relating to allegedly "thin capitalization." Most are stipulated, and those we consider controlling, in several areas, especially subordination, were included in findings by the Court of Appeals (e.g., pp. 6a, as to the 6½% debentures and 9a as to the 5½% notes). See also Appendices III-V. p. 27a ff.

Plainly, since the $1,078,000 total includes the 6½% debentures, the Court of Appeals, in effect, declines to consider the effects of the subordination of the 6½% debentures and, in the case of the $100,000 unsubordinated 5½% notes, the effects of the subordination of $509,878.33 thereof. We urge that each constitutes a plain error of law on the part of the Court of Appeals.

Indeed, as we have noted on p. 12, the Court of Appeals appears to have recognized that all of the 5½% notes would be held to constitute debt if the $150,000 of 6½% debentures were treated as the equivalent of equity. (p. 18a.)

The error of law involved is in the failure to give effect to consensual subordination in essential conflict with the decision of this Court in *United States* v. *Key*, and with the decisions of six Courts of Appeal cited on pages 20 and 21. We have not found any contrary authority in any federal appellate court. We do not deal here with the actual figures as to the debt-equity ratio, since they have already been sufficiently considered. (pp. 11-2)

The only intimation of any reason which may be assigned by the Court of Appeals for its failure to distinguish between the unsubordinated, and the subordinated, 5½% notes which we find is in the statement that many of the arguments made about the unsubordinated notes (erroneously called "debentures") are equally applicable for the remaining $509,878.33 of partially subordinated 5½% notes (p. 16a). New Plantation issued 55 such notes, one for each stockholder of Old Plantation for each of the eleven maturities of those notes (p. 8a). There is no limitation upon the right of those stockholders to take appropriate steps for enforcement, irrespective of action taken by the other holders, although any holder might waive a default (p. 29a).

We urge that the failure to treat the subordinated 5½% notes as a separate class, having priority over the 6½% debentures, is another error requiring reversal. The opinion of the Court of Appeals adequately establishes that we presented both of these

issues to it in such manner as to require separate decisions thereon, e.g., pp. 15a-17a.

There is confusion among the circuits and the Tax Court as to the applicable debt-equity ratios which, in the final analysis, can be only resolved by this Court. It is especially important that this be done in view of the issue respecting the guarantee question, since the legal rights and obligations of guarantors differ from those of a stockholder creditor of a corporate debtor.

Before considering the question of the right to recast the transaction, we take cognizance of the reason assigned by the Court of Appeals for refusing to disregard the effects of subordination of the 6½% debentures. We have already shown that subordination was not the "single factor" which might have influenced the courts below to arrive at a different conclusion about the 6½% debentures. The most significant of the reasons assigned for that treatment of the 5½% notes are also applicable to the debentures, and the capitalization is certainly thinner.

The opinion of the Court of Appeals then proceeds to say that this loan was made with the primary motive of inducing New Plantation to employ young Bradford (p. 23a). Certainly motive is irrelevant to any decision as to the effects of subordination, and supplies no justification for refusing to recognize those effects.

No doubt, somewhat similar considerations, namely kinship with the stockholders, influenced a relative to accept something less than true debt in *Foresun, Inc.* v. *Commissioner,* 348 F.2d 1006 (6th Cir., 1965). Yet, the obligations there considered were held to be equity rather than debt. Indeed, motives like these are calculated to influence a knowledgeable investor to accept

stock, or other types of equity, rather than to insist upon undoubted debt to represent his interest in a corporation.

An additional 1% interest on the principal amount of the debentures might also be considered a motive, one that is well recognized in the market place. Correspondingly, it may be assumed that New Plantation could have procured financing, in substantial sums, from its factor, if it had been willing to pay the interest rate required instead of supplying the guarantees of Jemison Investment Company and Mr. Jemison.

Since the Transaction Was Not a Sham, To Recast It as Was Done Below Is Contrary to Decisions of This Court Which Hold That Taxing Statutes Are To Be Construed Favorably to Taxpayers and That Taxpayers Are Not Required to Select a Procedure That Produces the Largest Amount of Taxes.

The effect, and the obvious purpose of the Commissioner in seeking to have all of the 5½% notes designated as equity, was to create a justification for double taxation resulting from the denial of an interest deduction to the corporation and the imposition of a tax on constructive dividends upon payment of the principal of the notes. While it is appropriate for courts to disregard devices which are designed to circumvent the plain purposes of the statutory system, the law is still said to be that tax statutes should be construed favorably to the taxpayer, e.g., *Burnet* v. *Niagara Falls Brewing Co.*, 282 U.S. 648 (1931); *Helvering* v. *Bliss*, 293 U.S. 144 (1934); *Lewyt Corporation* v. *Commissioner*, 349 U.S. 237 (1955); and *Commissioner* v. *Sullivan*, 356 U.S. 27 (1958).

The right of corporate taxpayers to an interest deduction is plainly granted. So, that basic principle of con-

struction declared in those decisions of this Court should be applied. Under *Burnet* v. *Niagara Falls Brewing Co.*, the principle requires some leniency in viewing the facts.

The petitioners urge that this is not a case in which the form of the transaction with respect to the availability of a deduction for interest and the effect of payment of principal of the 5½% notes should be disregarded on the theory that the substance was different from its form. A taxpayer is not required to adopt the form of transaction which will increase his tax liability, and when he adopts a form which is permitted by the statute, this should not be disregarded if it represents the true intent of the parties, and is not a sham. *U.S.* v. *Cumberland Public Service Co.*, 338 U.S. 451 (1950); *Commissioner* v. *Clay B. Brown, supra.*

The organization and functioning of New Plantation were not treated as a sham by the Tax Court or the Court of Appeals. Indeed, its existence is essential to procure the double taxation result in the case of the Jemisons for the year 1963.

If we are not dealing with a sham, we see no justification for restating the transaction. Organization of New Plantation was effective to insulate Mr. and Mrs. Jemison from liability to the holders of the 6½% debentures, and it gave to the holders of the 5½% notes a direct claim against that corporation.

Since some of the 5½% notes were not subordinated, the guarantors would, upon payment thereof, rank equally with the general creditors by subrogation under Section 87 of Title 9 of the Code of Alabama of 1940 (p. 19). The right to participate with general creditors is an important, though not necessarily in-

dispensable, element in determining whether the commitment of a corporation constitutes debt rather than equity, e.g., *Kraft Foods, Baker Commodities, Inc.,* and *George A. Nye.*

If, notwithstanding the taxpayers' rights to adopt a form of transaction which is permitted by the income tax law which has lower income tax implications than a form which increases the exposure to tax liability, there would be no justification for ignoring the fact that Jemison Investment Company, as well as Mr. Jemison, was a guarantor. Economic realities would make it more appropriate to have this corporation rather than Mr. Jemison treated as the primary obligor. But if the guarantors, rather than the corporation which is made the principal debtor by the documents, are to be treated as the primary obligors, then at least all of the guarantors should be so treated. This would supply substantial relief to the Jemisons.

The transaction is recast in two respects, the first to make Mr. Jemison the primary obligor. In the other, it is said that his guarantee was an indirect contribution of capital (pp. 23a, 12a). But that is most surely no more than a fiction or figure of speech, and is logically inconsistent with treatment of a guarantor as primary obligor. The guarantor does not contribute any property to the principal debtor.

In any event, even if Mr. Jemison is to be treated as the primary obligor, with or without relief from Jemison Investment Company, no liability can be asserted unless the debt-equity ratio is too high. Here we urge that the Court of Appeals, according to its own view of this question, erred in finding that all of the 5½% notes constituted equity. This view is copied on page 12 from page 18a.

CONCLUSION

The decision of the Court of Appeals deals erroneously with several matters of importance in the federal income tax field which may be expected to recur constantly. The position of guarantors of corporate debt needs to be made clear and the effects of subordination in the determination of what is so-called equity should be stated to conform with the decisions of the federal courts in bankruptcy proceedings. We respectfully request that the writ of certiorari be issued.

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APPENDIX I

UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT
October Term, 1970

No. 31126

T. C. Docket No. TC 3962-68 & 3967-68

PLANTATION PATTERNS, INCORPORATED, *Petitioner-Appellant*,
versus
COMMISSIONER OF INTERNAL REVENUE, *Respondent-Appellee*.
JOHN S. JEMISON, JR., and MARIE S. JEMISON,
versus
COMMISSIONER OF INTERNAL REVENUE, *Respondent-Appellee*.

Appeals from Decisions of the Tax Court of the United States (Alabama Case)

Before JONES, COLEMAN and SIMPSON, Circuit Judges.

Judgment

This cause came on to be heard on the transcript of the record of the Tax Court of the United States, and was argued by counsel;

ON CONSIDERATION WHEREOF, It is now here ordered and adjudged by this Court that the decisions of the said Tax Court in this cause be, and the same are hereby affirmed;

It is further ordered that petitioners-appellants pay to respondent-appellee the costs on appeal to be taxed by the Clerk of this Court.

June 15, 1972

Issued as Mandate:

IN THE UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

No. 31126

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(July 6, 1972)

On Petition for Rehearing

Before JONES, COLEMAN and SIMPSON, Circuit Judges.

PER CURIAM:

IT IS ORDERED that the petition for rehearing filed in the above entitled and numbered cause be and the same is hereby DENIED.

IN THE UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

No. 31126

PLANTATION PATTERNS, INCORPORATED, *Petitioner-Appellant,*
versus
COMMISSIONER OF INTERNAL REVENUE, *Respondent-Appellee.*

JOHN S. JEMISON, JR., and MARIE S. JEMISON,
Petitioners-Appellants,
versus
COMMISSIONER OF INTERNAL REVENUE, *Respondent-Appellee.*

Appeals from Decisions of the Tax Court of the United States (Alabama Case)
(June 15, 1972)

Before JONES, COLEMAN and SIMPSON, Circuit Judges.

SIMPSON, Circuit Judge: This is an appeal from a determination by the Tax Court of tax deficiencies against the corporate taxpayer, Plantation Patterns, Incorporated (New Plantation hereinafter, to distinguish it from an earlier corporation with the same name) for the fiscal years ending September 30, 1963-65, for the respective amounts of $2,947.12, $51,719.69, and $23,732.28, and

against the individual taxpayers, John S. Jemison, Jr. (Mr. Jemison) and his wife, Marie S. Jemison (Mrs. Jemison) of $28,403.91 for their taxable years 1963.[1] The cases were consolidated for trial in the Tax Court as they are for purposes of this appeal.

I. The Facts

Most of the relevant facts are stipulated. The New Plantation, an Alabama corporation, filed income tax returns, on the accrual basis, for its taxable years ended September 30, 1963 through September 30, 1965, with the office of the District Director of Internal Revenue, Birmingham, Alabama. The individual taxpayers also filed their joint income tax return for their taxable year ended December 31, 1963, with the Birmingham District Director at Birmingham.

New Plantation's corporate predecessor, which was also called Plantation Patterns, Inc. (Old Plantation) was engaged in the business of manufacturing wrought iron furniture in Birmingham, Alabama, from the time of its incorporation in 1956 until September 28, 1962.

Prior to September 28, 1962, the stockholders of Old Plantation and the outstanding shares therein were owned as follows:

	Number of Shares
Thomas E. Jernigan	162,483
William C. Jernigan	80,718
John M. Goodwin	8,812
H. Ferrell Jernigan	353
James C. Stone	17,624
Total	270,000

[1] The memorandum findings of fact and opinion of the Tax Court is reported at P-H Memo T.C. par. 70,182 (1970). Jurisdiction is conferred on this Court by Section 7482 of the Internal Revenue Code of 1954.

Before that date Mr. Thomas E. Jernigan was president and Mr. William C. Jernigan was vice president and secretary of Old Plantation.

During the spring of 1962, Old Plantation made plans for a public offering of 100,000 shares of its common stock in order to raise funds to develop the United Chair Division and to permit Old Plantation to operate both the wrought iron furniture business and the United Chair Division's metal office chair business. This public offering was not consummated. Messrs. Thomas E. and William C. Jernigan then decided that it would be in their best interests to sell the wrought iron furniture business of Old Plantation and to develop the United Chair Division's metal office chair business.

During the summer of 1962, the shareholders of Old Plantation decided that they would attempt to sell their interests in both the wrought iron furniture and metal office chair businesses by sale of their Old Plantation stock. In July of 1962, Mr. Jack Parish, a member of the accounting firm that had worked on the prospectus for the proposed public offering of Old Plantation stock, contacted Mr. John S. Jemison, Jr., the president and controlling shareholder of Jemison Investment Co., Inc., and inquired if he would be interested in purchasing or finding a purchaser for the stock of Old Plantation.

At that time Mr. Jemison was an experienced investment banker, having been in that business for at least twenty years. As an investment banker, he had arranged for the acquisition of businesses, both for Jemison Investment Co., Inc. clients and for its own account—both as purchases of assets and as purchases of stock. Mr. Jemison had become a member of the board of directors of a number of corporations.

Jemison Investment Co., Inc. had acted as agent or broker for purchasers and sellers of businesses since its

organization by Mr. Jemison in 1949. During 1962, Jemison Investment Co., Inc. had assets of eleven million dollars, including a number of wholly owned subsidiaries, such as a transit company that operated the city bus system in Birmingham, Alabama, a company that manufactured window frames in Chicago, Illinois and operated a textile mill in North Carolina, and corporations that operated department stores in St. Petersburg, Florida, and Tuscaloosa, Alabama.

The accountant Parish arranged for negotiations in July and August, 1962, between Messrs. Jemison and Thomas E. Jernigan concerning the sale of Old Plantation. These negotiations led to a general understanding between Messrs. Jemison and Thomas E. Jernigan that a corporation would be formed to purchase all the stock of Old Plantation and that Old Plantation would sell its United Chair Division's metal office chair business to Messrs. Thomas E. and William C. Jernigan.

A letter addressed to Mr. Thomas E. Jernigan dated August 24, 1962, on the letterhead of Jemison Investment Co., Inc. and signed by Mr. Jemison, set forth a conditional offer to purchase the "assets of the Plantation Patterns Division". This letter stated:

> "We would organize a new corporation to be known as Plantation Patterns Corporation (it is understood that you would agree to change the name of the existing corporation) and we would pay in a total of $155,000. in cash—$150,000. in 6½% subordinated notes—which notes would be subordinated to your notes—and $5,000. in common stock."

On September 25, 1962, Mr. Jemison caused New Plantation to be organized under the laws of the State of Alabama. Upon its incorporation, New Plantation issued ten shares of common stock with a par value of $100 per share to its incorporators. On the same date that it was

incorporated, the incorporators transferred those ten shares of stock to Mrs. Marie S. Jemison.

'On September 26, 1962, New Plantation issued an additional 40 shares of common stock to Mrs. Jemison for a price of $4,000 cash. Mrs. Jemison paid for this additional 40 shares and her initial ten shares of stock by her check for $5,000 dated September 26, 1962. The record does not indicate whether or not the funds for the purchase of the stock came from the separate estate of Mrs. Jemison. The total capital stock of New Plantation, consisting of the 50 shares of common stock held by Mrs. Jemison, remained at $5,000 through September 30, 1966.

Mrs. Jemison took no active part in the preliminary negotiations leading up to the incorporation of New Plantation on September 25, 1962, in any of the events that took place thereafter, or in the management of New Plantation from the time it was incorporated to September 30, 1966, inclusive. Mrs. Jemison, her husband and Mr. Thomas Bradford were the directors of New Plantation. A meeting of the directors and a joint meeting of the directors and stockholders of New Plantation took place on September 28, 1962. Although Mrs. Jemison was the sole shareholder of record and a director, she attended neither meeting. Mr. Jemison was active in the management of New Plantation. Mr. Jemison testified that he had contacts with large department stores that sold wrought iron furniture.

On September 27, 1962, New Plantation obtained $150,000 from Bradford and Company, Inc., an unrelated finance and investment company, for which it issued 6½% serial debentures aggregating $150,000 maturing in $50,000 units on September 1, 1974, 1975, and 1976. The debentures were subordinated to all other indebtedness of New Plantation and were not guaranteed as to payment of either principal or interest. Mr. Thomas Bradford controlled Bradford and Company. The loan by Bradford and Com-

pany was made as an inducement to Mr. Jemison to place Mr. Bradford's son with New Plantation. Although this advance was made with little security and no priority as to repayment, the Tax Court found that it was a bona fide loan.

The sellers accepted, with modifications, the proposal made in the Jemison letter of August 24, 1962, and the terms of sale were embodied in an agreement dated September 28, 1962 between New Plantation and the stockholders of Old Plantation. Pursuant to that agreement, the stockholders agreed to sell and New Plantation agreed to buy the stock of Old Plantation for a stated consideration equal to the net worth of Old Plantation plus $644,909.53. The total purchase price was to be paid as follows:

(1) A cash payment of $100,000 at the time of closing;

(2) An amount equal to the book value of the United Chair Division ($183,435.84), without interest, in installments on January 10, 1963, March 15, 1963 and June 15, 1963;[2] and

(3) The balance ($609,878.33) in equal installments of $50,000 beginning October 1, 1963, and each year thereafter, with a final installment of $109,878.33 due on October 1, 1973. The notes representing such installments were to be guaranteed by the Jemison Investment Company and by Mr. Jemison, personally.

Pursuant to the agreement of September 28, 1962 Mr. Thomas E. Jernigan agreed to serve as president and chief executive officer of New Plantation for two years beginning October 1, 1962.

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[2] In turn, Messrs. Thomas E. Jernigan and William C. Jernigan agreed to purchase the assets of the United Chair Division for the same amount payable on the same terms.

Further pursuant to the agreement of September 28, 1962, the stockholders of Old Plantation transferred their stock to New Plantation for a stated consideration of $893,314.17, of which $100,000 was paid in cash at the time of the sale, and the balance of $793,314.17 was payable in installments—three totaling $183,435.84 in 1963, with no interest; and $609,878.33 at 5½% interest, payable in ten annual installments of $50,000 each on October 1 of 1963 through 1972, and a final installment on October 1, 1973, of $109,878.33.

New Plantation issued 15 non-interest-bearing notes aggregating $183,435.84 to evidence the payments due January 10, 1963, March 15, 1963 and June 15, 1963. These notes were not guaranteed and the *indebtedness was subordinated to all other indebtedness of New Plantation except the* $150,000 owed to Bradford and Company.[3] The parties who negotiated the agreement intended that payment of these notes would be effected through the sale by Old Plantation of its United Chair Division's metal office chair business to Messrs. Thomas E. and William C. Jernigan.

New Plantation also issued fifty-five 5½% serial notes aggregating $609,878.33 to evidence the remaining payments due on account of the purchase of the stock. These notes were guaranteed absolutely as to principal and interest by Mr. Jemison individually and by the Jemison Investment Co., Inc. Jemison Investment Co., Inc. received a guarantee fee of $15,000 per year for its guarantee. Mr. Jemison did not receive any fee for his guarantee. The guarantees were required due to the small down payment made on the purchase and the requirement that the debt be unsecured to enable New Plantation to obtain financing for its operations.

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[3] The Commissioner conceded that the principal payments on these non-interest-bearing notes did not result in dividend income to the Jemisons.

The notes for $50,000 due October 1, 1963 and $50,000 due October 1, 1964 were not subordinated so that Mr. Jemison could arrange for the sellers to discount these notes with a bank. This enabled Messrs. Thomas E. and William C. Jernigan to obtain additional capital for development of the office chair business. The remaining notes were subordinated to all other indebtedness except the 6½% serial debentures issued to Bradford and Company.

Pursuant to another agreement dated September 28, 1962, Old Plantation agreed to sell the assets of its United Chair Division to Messrs. Thomas E. and William C. Jernigan, effective as of the close of business on August 31, 1962. In consideration for that sale, Messrs. Thomas E. and William C. Jernigan agreed to pay to Old Plantation the sum of $183,435.84. In its final return Old Plantation reported that its basis in the assets of the United Chair Division equaled the proceeds received on that sale.

As of September 28, 1962, Old Plantation was liquidated. Its assets were transferred to and its liabilities were assumed by New Plantation.[4] Following the liquidation of Old Plantation, the business and assets of the United Chair Division were immediately transferred to Messrs. Thomas E. and William C. Jernigan, who issued to New Plantation a non-interest-bearing promissory note dated September 28, 1962 in the principal amount of $183,435.84 payable as follows:

Due Date	Amount
October 8, 1962	$ 83,435.84
March 15, 1963	50,000.00
June 15, 1963	50,000.00
Total	$183,435.84

[4] The Commissioner contended in the Tax Court that the fair market of the inventory among the tangible assets received by New Plantation was $184,936.04 as shown on its returns. The Tax Court held that the fair market value of the inventory was $228,376.12. The Commissioner has not appealed from that determination.

The Messrs. Jernigan duly made the payments on this note on or before the due date, while New Plantation similarly paid the non-interest-bearing notes aggregating $183,435.84 due January 10, 1963, March 14, 1963 and June 14, 1963. As a result, the United Chair Division was acquired by Messrs. Thomas E. and William C. Jernigan through an exchange or offset of notes.

During the period from October 1, 1962 to September 30, 1966, New Plantation duly paid principal and interest as due on the 6½% debentures issued to Bradford and Company and on the 5½% notes issued to the stockholders of Old Plantation. The payments were made by New Plantation without recourse to any additional financing.

During its four taxable years ended September 30, 1963 through September 30, 1966, New Plantation accrued $117,652.65 interest expense on the 5½% serial notes issued to the shareholders of Old Plantation, and $39,000 on the 6½% debentures issued to Bradford and Company, which amounts it deducted on its tax returns filed for those years as the Tax Court noted in its findings of fact.

In the notice of deficiency sent to New Plantation for its taxable years ended September 30, 1963 through September 30, 1966, inclusive, the Commissioner disallowed as an expense the deductions claimed by New Plantation for such interest.[5]

In its return for the period September 25 to September 30, 1962, New Plantation reported assets received (according to a computation of the adjusted basis of its stock on September 28, 1962, and the allocation of that adjusted basis to the assets received in liquidation from Old Plantation, as shown in the Tax Court's findings) and liabilities assumed on the liquidation of Old Plantation.

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[5] The Commissioner conceded in the Tax Court that New Plantation was entitled to an expense deduction for the $39,000 interest paid on the 6½% debentures issued to Bradford and Company.

The sum of $184,936.04 shown as the fair market value of the inventory in the schedules included by New Plantation in its return represented the book value of the inventory of Old Plantation computed as the lower of average cost or market. The Tax Court determined that the fair market value of the inventory received by New Plantation on the liquidation was $228,376.12 (Note 4, supra) and that New Plantation otherwise properly valued the tangible assets on the liquidation.[6]

In the notice of deficiency addressed to Mr. and Mrs. Jemison for the calendar year 1963, the Commissioner determined that the individual taxpayers realized dividends in the amount of $184,274.23 on account of the following payments by Old Plantation:

Payment of non-interest-bearing note due 3/14/63	$ 50,000.00
Payment of non-interest bearing note due 6/15/63	50,000.00
Payment of 5½% note due 10/1/63	50,000.00
Payment of interest on 5½% note due 10/1/63	33,543.31
Payment on account of 5½% note of minority stockholder on 10/24/63	730.92
Total	$184,274.23

[6] Thus on September 30, 1962, New Plantation's balance sheet looked like this:

ASSETS		*VALUES*
Cash		$ 54,038.26
Accounts receivable-trade	$36,570.71	
Allowance for bad debts	3,000.00	$ 33,570.71
Accounts receivable-other		229,050.25
Inventories		228,376.12
Prepaid expenses		24,901.80
Employees' advance		1,705.66
Travel advance		500.00
Machinery and equipment		391,028.50
Truck		525.00

The Tax Court held that all steps taken by Mr. Jemison and the shareholders of Old Plantation were parts of a single transaction for the purchase by New Plantation of the wrought iron furniture business of Old Plantation, and, applying the relevant factors with respect to debt-equity situations to the facts here, one of which was found to be thin capitalization, that the guaranteed debt must be treated as an indirect contribution to New Plantation's capital by Mr. Jemison. Therefore, it held that New Plantation was not entitled to deductions claimed under Code Section 163 for interest on the 5½% serial notes in its taxable years ended September 30, 1963 to September 30,

Office equipment		18,733.00
Leasehold improvements		37,374.50
Goodwill		199,060.70
Long-term lease		42,463.31
		$1,261,327.81

LIABILITIES

Notes payable-current installments		$ 221,446.00
Due to factor		83,362.83
Accounts payable-trade		55,279.89
Accrued salaries, wages and commissions		8,329.80
Accrued payroll and taxes withheld from employees		12,840.46
Accrued bonus and vacation pay		12,822.44
Accounts payable to former stockholders		4,708.62
Accrued state and local taxes		3,079.39
Federal and state taxes on income		92,383.11
Long term debt		
Unsubordinated 5½% notes	$100,000.00	
Partially subordinated 5½% notes	$509,878.33	
Fully subordinated 6½% debentures	150,000.00	
Other notes payable	2,196.94	
		$ 762,075.27
Common stock		5,000.00
		$1,261,327.81

1966 and that the Jemisons were taxable in 1963 under Code Sections 301 and 316 with the principal and interest payments on these guaranteed notes in that year.[1] Their deficiency was fixed at $28,403.91.

II. The Issues on Appeal

The issues presented for our consideration are these:

1. Whether $100,000 of guaranteed 5½% serial debentures issued by New Plantation to the sellers of Old Plantation are to be treated as debt for income tax purposes where the notes were not subordinated and were paid when due by New Plantation without recourse to other financing?

2. Whether $309,878.33 of guaranteed 5½% notes issued by New Plantation to the sellers of Old Plantation are to be treated as debt for income tax purposes where the notes were subordinated to general creditors but were senior to $150,000 of other debentures which the Tax Court did treat as debt for income tax purposes?

3. Whether Jemison Investment Company, a co-guarantor, rather than John S. Jemison, Jr., a co-guarantor, should be deemed to have made the contribution to the equity capital of New Plantation in the event that any of the $609,878.33 principal amount of 5½% notes is deemed to represent a contribution to the equity capital of New Plantation?

III. The Relevant Law

The criteria for adjudicating debt-equity cases were set forth most clearly by Judge Jones for this Court in 1963 in *Montclair, Inc.* v. *C.I.R.*, 5 Cir. 1963, 318 F.2d 38. At page 40 of Volume 318 F.2d the factors which bear most strongly on the determination of the label to be applied to the transaction are enunciated:

> "(1) the names given to the certificates evidencing the indebtedness; (2) the presence or absence of a

[1] The Tax Court allowed the Jemisons a deduction for interest paid the sellers by New Plantation.

maturity date; (3) the source of the payments; (4) the right to enforce the payment of principal and interest; (5) participation in management; (6) a status equal to or inferior to that of regular corporate creditors; (7) the intent of the parties; (8) 'thin' or adequate capitalization; (9) identity of interest between creditor and stockholder; (10) payment of interest only out of 'dividend' money; (11) the ability of the corporation to obtain loans from outside lending institutions."[8]

Since *Montclair, Inc.* consideration of debt-equity cases has frequently demanded the attention of this Court. See, e.g., *In Re Indian Lake Estates, Inc.*, Bankrupt, 5 Cir. 1971, 448 F.2d 574, 577; *Dillin* v. *United States*, 5 Cir. 1970, 433 F.2d 1097; *Tyler* v. *Tomlinson*, 5 Cir. 1969, 414 F.2d 844; *Berkowitz* v. *United States*, 5 Cir. 1969, 411 F.2d 818; *Harlan, et al* v. *United States*, 5 Cir. 1969, 419 F.2d 904; *Tomlinson* v. *1661 Corporation*, 5 Cir. 1967, 377 F.2d 291; *United States* v. *Henderson*, 5 Cir. 1967, 375 F.2d 36. In applying these factors, each case must be decided on its own facts and no one standard is controlling. See generally the cases just cited, supra. The tests are not "talismans of magical power", and the most that can be said is that they are a source of helpful guidance. *Tyler* v. *Tomlinson*, supra. Thus we decide debt-equity issues by a case by case analysis, applying the *Montclair* rubrics as best we can to the facts at hand.

IV. Treatment of the $100,000 Unsubordinated 5½% Debentures and the $509,878.33 Partially Subordinated 5½% Notes

With regard to the $100,000 unsubordinated debentures, the taxpayers urge us to reverse the Tax Court for the following reasons: (1) There was a reasonable prospect

[8] This delineation was not intended to prevent the consideration of other factors which may be relevant in a particular case. See *Dillin* v. *United States*, 5 Cir. 1970, 433 F.2d 1097 at footnote 3, page 1100.

of payment when due, (2) the notes were not subordinated to any other indebtedness of New Plantation, (3) the holders, along with general creditors, had first claim on more than $1,000,000 in assets of New Plantation, (4) the notes matured within two years, (5) the notes could have been paid by New Plantation's cash flow, and (6) the notes were paid when due without recourse to additional financing.

Of these factors, taxpayers point first and foremost to the fact that the debentures were totally unsubordinated, and thus conferred on the holders the right to participate with general creditors. They further call to our attention that under the Code of Alabama had the creditors paid the notes their subrogation rights would have permitted them to participate in any insolvency proceeding as a general creditor. Section 87, Title 9, Code of Alabama of 1940, as amended.

Taxpayers also vigorously assert that the assets of the corporation were more than adequate to support the $100,000 unsubordinated notes because on September 30, 1962, New Plantation's assets had a fair market value of $1,261,327.81, Note 6, supra. Central to this appeal is the taxpayers' contention that the Tax Court erroneously concluded that New Plantation was thinly capitalized.

Additionally, with regard to the $100,000 of unsubordinated 5½% debentures, taxpayers emphasize that they were to mature within two years, a factor militating strongly against a conclusion that the money was put "at the risk" of the business. Bolstering this point, taxpayers state that the cash flow from depreciation in 1963 and 1964, the years of payment of the $100,000 notes, exceeded the principal payments of $50,000 due on the notes. They say that in view of the fact that the interest on the notes is deducted in determining net income, it was not necessary for New Plantation to have net income to pay these notes, and thus their repayment was not contingent on the profitability of the business.

Finally, the taxpayers criticize the Tax Court for not giving greater weight in assessing the economic realities of the situation to the fact that the notes were paid on time. Taxpayers claim that giving this development its proper weight will lead us to the conclusion that the Tax Court was clearly erroneous in its holding that when the notes were issued there was no reasonable expectation that New Plantation could pay the notes. In this regard taxpayers also insist that the Tax Court gave undue emphasis to the overall debt-equity ratio, which they assert bears slight relevance to the determination of the treatment given unsubordinated notes. Taxpayers argue that whether a corporation can pay *all* of its debts is irrelevant to the question of whether it can pay its priority debts.

Turning to the remaining $509,878.33 of partially subordinated 5½% serial debentures, the taxpayers argue five points in support of their proposition that the Tax Court erred: (1) There was reasonable prospect of payment when due, (2) the notes, though partially subordinated, were senior to $150,000 of 6½% debentures and $5,000 of common stock, (3) the assets of New Plantation were sufficient to support the debt, (4) the cash flow was sufficient to pay the debt, and (5) the notes were paid when due without recourse to additional financing.

Many of the arguments made by the taxpayers in favor of debt treatment for the $100,000 unsubordinated debentures are equally applicable for the remaining $509,878.33 of partially subordinated notes, and the taxpayers have urged us to accord them equal vitality here. New arguments also are raised at this juncture, however. Taxpayers contend that it is anomalous and inconsistent for the Tax Court to characterize the $509,878.33 partially subordinated debentures as equity while at the same time characterizing inferior fully subordinated debentures held by Bradford and Company as debt, arguing that if the fully subordinated 6½% notes held by Bradford and Company

are equity, surely the $509,878.33 debentures are entitled to the same treatment.

Here the taxpayers protest vigorously against the Tax Court's determination of the proper debt-equity ratio to apply in assessing the nature of the transaction. The principal dispute with the Tax Court revolves about that Court's valuation of the intangible assets of New Plantation, with particular emphasis on the personal business skills of Mr. Jemison. The Tax Court did recognize that intangible assets not carried on the balance sheet might have a bearing on the ability of the corporation to pay its debts. *Murphy Logging Company* v. *United States*, 9 Cir. 1967, 378 F.2d 222. But the Tax Court held that the relationship of Mr. Jemison's business skills to the well-being of New Plantation was not demonstrated with the specificity requisite to alter the picture of the overall debt-paying potential of New Plantation. Relying heavily on *Murphy Logging*, supra, the taxpayers contend that the record amply demonstrates that Mr. Jemison was a veritable financial genius, commanding Jemison Investment Company, a company with control of assets valued at more than $11,000,000 and with annual gross receipts of over $10,000,000. They point to the record as reflecting that Mr. Jemison was successfully engaged in a broad variety of business ventures. He was a director of several successful corporations, a bank, and two insurance companies. More important, however, taxpayers assert, is Mr. Jemison's demonstrated close contact with several large department store chains which provided ideal outlets for New Plantation's products. Taxpayer on this account urges that a proper debt-equity ratio should take into account the financial skills of Mr. Jemison.

Without receding from their strong stand that the 5½% debentures constitute debt, the taxpayers alternatively argue that if the court should hold that such notes do not constitute debt, the same equity treatment should be given

to the 6½% subordinated debentures held by Bradford and Company. Stated otherwise, they argue that if the 5½% *partially* subordinated debentures are to be regarded as equity, then the 6½% totally subordinated debentures should logically be deemed to constitute preferred stock in New Plantation. Taxpayers point out that long-term debt held by non-stockholders has been held to be an equity interest in the nature of preferred stock. *Foresun, Inc.* v. *Commissioner*, 6 Cir. 1965, 348 F.2d 1006, affirming 41 T.C. 706 (1964). Taxpayers claim that they were denied the right to further trial on this point in the Tax Court, and they contend that at the very least this Court should remand the case to the Tax Court to permit development of further evidence as to the treatment to be given the $150,000 in Bradford and Company notes. If these notes are regarded as equity, taxpayers argue that the debt-equity ratio of New Plantation would be approximately 4 to 1 ($609,878.33 to $155,000), and not the plus 125 to 1 ratio which the government asserts is the proper debt-equity ratio ($759,878.33 to $5,000). This would effectively demolish the Tax Court finding of thin capitalization.

The Commissioner answers these contentions with the familiar tax law precept: substance and not form determines proper tax treatment for a transaction, urging that the substance of this transaction is that a corporation was sold for a price more than $600,000 in excess of its net worth, with payment promised by a new corporation without significant capital or other assets, whose only solidarity was the guarantee of the individual taxpayer, Mr. Jemison. The Commissioner continues that the guarantee was in reality a contribution of capital and that in substance the payments on the notes were dividends on the Jemison capital investment taxable to them as income.

More specifically the Commissioner places primary emphasis on the Tax Court's findings that the assets of the new corporation vis a vis its debts were insufficient to give

New Plantation viable independence as a corporation. The Tax Court found that the corporate assets of New Plantation were "wholly inadequate to sustain a debt of $609,878.33". The Commissioner suggests that *Murphy Logging*, supra, the keystone in appellants' argument, is distinguishable. The Commissioner argues that in *Murphy Logging*, the guarantee of a guarantor-stockholder was held not significant because the corporation had substantial ability to meet its debts without the aid of a guarantor, a factor absent in this case. Further distinction is noted in that in *Murphy Logging* the Ninth Circuit was not dealing with a thinly capitalized corporation, as is the case here. The Commissioner discounts the fact that New Plantation was in actuality able to pay its obligations without resort to its guarantors, pointing out that we must view the transaction on the basis of the economic realities as they existed at New Plantation's inception, and not in the light of later developments. As matters stood September 28, 1962, asserts the Commissioner, the deal had not set up a bona fide corporation reasonably to be expected to manage to go it alone, and later developments do not alter the nature of the transaction for tax purposes.

Making further use of the debt vs. equity criteria established by *Montclair* and later cases, the Commissioner notes particularly that the sellers took the unusual step of agreeing to subordinate all but $100,000 of the purchase money notes. The Commissioner asserts that this action was taken because the sellers looked first and foremost to the guarantee of Mr. Jemison, an obligation which was primary in nature.

The Commissioner also claims that no third party arm's-length creditors, because of New Plantation's paper thin capitalization, would have loaned the amount of money by which the corporation became indebted. Establishment of any indebtedness, argues the respondent, would have required Mr. Jemison's guarantee, and therefore for tax pur-

poses the indebtedness should be regarded as that of the Jemisons.

Resolving these two conflicting views of this amorphous transaction is no easy task, but we are not persuaded that the taxpayers have successfully demonstrated the incorrectness of the position taken by the Tax Court. Certainly we recognize that this transaction was initially cast to have all of the outward appearances of a debt transaction, complete with instruments styled "debentures" which had fixed maturity dates. But these surface considerations do not end our examination. Closer scrutiny establishes that the other factors which would give the transaction the aura of debt are noticeable by their absence.

Of critical importance in determining whether financial input is debt or equity is whether or not the money is expended for capital assets. In the instant case the substantial portion of the $609,878.33 was directed to the purchase of capital assets and to finance initial operations. In contrast, only $5,000.00 was set up as equity to finance launching of the corporate venture.

Other equity factors exist. While the sellers were ostensibly to look to the corporation for payment of the debt, it is apparent from the meager capital position of the company that Mr. Jemison's guarantee was regarded as the real undergirding for the deal. Our conclusion is reinforced by noting that the sellers apparently considered financially acceptable the agreement to subordinate the great majority of the 5½% debentures to almost all other corporate indebtedness so long as the debentures were guaranteed by Mr. Jemison. Mr. Jemison's guarantee was, of course, an obligation primary in nature.

Further, while Mrs. Jemison was the stockholder of record, and Mr. Jemison on the surface was only a guarantor, surrounding circumstances clearly demonstrate that Mr. Jemison completely controlled the shares held by Mrs.

Jemison. Mrs. Jemison seldom attended the meetings of the corporation, and took little active interest in it. In contrast, Mr. Jemison was intimately and continuously involved in the operations of New Plantation. Regarding Mr. Jemison as the "constructive" owner of the stock, we have an identity of interest between the stockholder and the guarantor—a factor which points strongly toward equity treatment.

The record cannot support a determination by us that the Tax Court's finding that New Plantation was thinly capitalized is "clearly erroneous".[9] The balance sheet of the corporation showed that its quick assets (cash and accounts receivables) of $317,000 could not cover its current liabilities of approximately $490,000. This ratio is one of the acid test indicators used by businessmen to determine the health of a business. After the dissolution of Old Plantation the new corporation had tangible assets, at fair market value, of approximately $1,064,000 securing debts of approximately $1,078,000. We regard this as thin capitalization, as did the Tax Court.

The guarantee enabled Mr. Jemison to put a minimum amount of cash into New Plantation immediately, and to avoid any further cash investment in the corporation unless and until it should fall on hard times. At the same time he exercised total control over its management. Adding together the personal guarantee of Mr. Jemison to the guarantee of Jemison Investment Company, which was wholly owned by him and Mr. Jemison's control of New Plantation, we think that the result is that Mr. Jemison's guarantee simply amounted to a covert way of putting his money "at the risk of the business". Stated differently, the guarantee enabled Mr. Jemison to create borrowing power for the corporation which normally would have ex-

[9] Rule 52(a), Federal Rules of Civil Procedure, under which we review decisions of the Tax Court. See Section 7482(a), Internal Revenue Code of 1954, Title 26, U.S. Code, Section 7482(a).

isted only through the presence of more adequate capitalization of New Plantation.

We do not regard as significant the fact that ultimately things progressed smoothly for New Plantation and that its debts were paid without additional financing. The question is not whether, looking back in time, the transaction was ultimately successful or not, but rather whether at its inception there was a reasonable expectation that the business would succeed on its own. The transaction must be judged on the conditions that existed when the deal was consummated, and not on conditions as they developed with the passage of time. See Mertens Law of Federal Income Taxation, Vol. 4A (1966 Revision) Sec. 26.10c, Ch. 26, page 75; *Moughon* v. *C.I.R.*, 6 Cir. 1964, 329 F.2d 399, 401. When New Plantation was incorporated its prospects of business success were questionable indeed without the Jemison guarantees.

We hold also that the Tax Court was correct in refusing to give value to the intangible financial skills of Mr. Jemison for purposes of computing the corporation's debt-equity ratio. We reach this decision despite noting appellants' contention that the showing here of relation of Mr. Jemison's skills to the well-being of New Plantation is much stronger than the showing of intangible stockholder assets which were considered relevant in *Murphy Logging*, supra.[10] We are bound by decisions of the Ninth Circuit only as we find them persuasive. In our view courts should be wary in giving weight to such intangible assets as those attributed to Mr. Jemison. Certainly business acumen or financial wizardry of stockholders or corporate management could not properly be valued and placed on the corporate balance sheet under generally accepted principles of accounting, although they might afford window dressing in

[10] The appellants have attached to their brief a copy of a portion of the *Murphy Logging* record dealing with intangible contributions by its stockholders.

a footnote. With deference to the Ninth Circuit, we conclude that intangible assets such as those claimed for Mr. Jemison have no place in assessing debt-equity ratio unless it can be shown by convincing evidence that the intangible asset has a direct and primary relationship to the well-being of the corporation. Additionally it seems clear to us that the assets sought to be valued must be something more than management skills and normal business contacts. These are expected of management in the direction of any corporation.

We decide only this case. We do not assert that intangible assets are never a proper consideration in assessing debt-equity ratio. Nevertheless we agree with the Tax Court that courts should proceed cautiously in giving value to such intangible assets in the absence of special circumstances demonstrating a primary relationship to the corporation. That standard is not met by evidence that Mr. Jemison was a talented business man with useful contacts among department stores.

Our holding does not require that we find the notes held by Bradford and Company to be equity interests. While the Bradford and Company notes were subordinated, subordination is far from the sole criterion for determining whether an interest is debt or equity. It is not controlling. Aside from this single factor this record is productive of nothing to indicate that this was not a bona fide loan made by Bradford with the primary motive of inducing New Plantation to employ young Bradford. We agree with the Tax Court that this was a legitimate loan.

V. Should the Equity Contribution Be Deemed to Have Been Made by Jemison Investment Company Rather Than by Mr. Jemison?

The Tax Court found that the equity contribution was to be attributed to Mr. Jemison and not to Jemison Investment Company. Although acknowledging that Jemison In-

vestment Company received a fee of $15,000.00 for its guarantee on the notes, the Tax Court reasoned that inasmuch as Mr. Jemison controlled both Jemison Investment and New Plantation, the fee for the guarantee was either a matter of internal accounting or for cosmetic effect, and not an indication that the sellers of Old Plantation realistically looked to Jemison Investment Company for any security. It is uncontested that practically all of Mr. Jemison's assets consisted of stock in Jemison Investment Company. It owned the house he lived in and the automobile he drove, but he owned it in its entirety. Furthermore, the Tax Court found that the sellers of Old Plantation only investigated the credit of Mr. Jemison, and that the Messrs. Jernigans as sellers looked at all times to Mr. Jemison's guarantee as the real insurance for the notes.

Although the appellants cast some doubt on the Tax Court's finding that the sellers did not investigate the financial statements of the Jemison Investment Company, in no other respect have they demonstrated error in the Tax Court's conclusion that through all of the haze of corporate red tape, the real financial keystone supporting the entire deal, the person to whom the sellers ultimately looked for their protection in the event of the failure of New Plantation was Mr. John S. Jemison, Jr.

VI. Conclusion

Error is not demonstrated on this record. None of the Tax Court's Findings and Conclusions based upon stipulated facts are shown to be "clearly erroneous". The decision of the Tax Court as to all matters raised by this appeal is

Affirmed.

APPENDIX II

SEC. 163. INTEREST.

(a) General Rule.—There shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness.

SEC. 301. DISTRIBUTIONS OF PROPERTY.

(a) In General.—Except as otherwise provided in this chapter, a distribution of property (as defined in section 317(a)) made by a corporation to a shareholder with respect to its stock shall be treated in the manner provided in subsection (c).

. . . .

(c) Amount Taxable.—In the case of a distribution to which subsection (a) applies—

(1) Amount constituting dividend.—That portion of the distribution which is a dividend (as defined in section 316) shall be included in gross income.

SEC. 302. DISTRIBUTIONS IN REDEMPTION OF STOCK.

. . . .

(d) Redemptions Treated as Distributions of Property.—Except as otherwise provided in this subchapter, if a corporation redeems its stock (within the meaning of section 317(b)), and if subsection (a) of this section does not apply, such redemption shall be treated as a distribution of property to which section 301 applies.

SEC. 316. DIVIDEND DEFINED.

(a) General Rule.—For purposes of this subtitle, the term "dividend" means any distribution of property made by a corporation to its shareholders—

(1) out of its earnings and profits accumulated after February 28, 1913, or

(2) out of its earnings and profits of the taxable year (computed as of the close of the taxable year

without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made. Except as otherwise provided in this subtitle, every distribution is made out of earnings and profits to the extent thereof, and from the most recently accumulated earnings and profits. To the extent that any distribution is, under any provision of this subchapter, treated as a distribution of property to which section 301 applies, such distribution shall be treated as a distribution of property for purposes of this subsection.

SEC. 317. OTHER DEFINITIONS.

. . . .

(b) Redemption of Stock.—For purposes of this part, stock shall be treated as redeemed by a corporation if the corporation acquires its stock from a shareholder in exchange for property, whether or not the stock so acquired is cancelled, retired, or held as treasury stock.

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APPENDIX III

Dated September 28, 1962
No. A-1

$30,091.38

PLANTPAT, INC.
5½% SERIAL NOTE (SUBORDINATED)
DUE OCTOBER 1, 1963

PLANTPAT, INC., an Alabama corporation (herein called "the Company"), for value received hereby promises to pay to Thomas E. Jernigan or order on October 1, 1963, at the office of The First National Bank, Birmingham, Alabama, the principal sum of Thirty Thousand Ninety-One & 38/100 Dollars ($30,091.38) in such coin or currency of the United States of America as at the time of payment shall be legal tender for the payment of debts and to pay interest on the principal sum hereof at the rate of 5½% per annum at such office in like coin or currency from the date hereof, annually on the 1st day of September, 1963, and on the 1st day of each succeeding September until payment of the principal sum has been made or duly provided for.

This note is one of an issue of fifty-five (55) notes known as Plantpat, Inc. 5½% Serial Notes (Subordinated) limited to the aggregate principal amount of Six Hundred Nine Thousand Eight Hundred Seventy-Eight & 22/100 Dollars ($609,878.33) maturing serially in the following respective amounts:

Note No. A-	B-	C-	Maturity Dates	Principal Amount of Such Notes A-	B-	C-
1	1	1	Oct. 1, 1963	$30,091.38	$14,947.78	$3,263.71
2	2	2	" " 1964	30,091.38	14,947.78	3,263.71
3	3	3	" " 1965	30,091.38	14,947.78	3,263.71
4	4	4	" " 1966	30,091.38	14,947.78	3,263.71
5	5	5	" " 1967	30,091.38	14,947.78	3,263.71
6	6	6	" " 1968	30,091.38	14,947.78	3,263.71
7	7	7	" " 1969	30,091.38	14,947.78	3,263.71
8	8	8	" " 1970	30,091.38	14,947.78	3,263.71
9	9	9	" " 1971	30,091.38	14,947.78	3,263.71
10	10	10	" " 1972	30,091.38	14,947.78	3,263.71
11	11	11	" " 1973	66,127.81	32,848.74	7,172.22

DO CLOSE IN CENTER

Note No. D-	Note No. E-	Maturity Dates	Principal Amount of Such Note D-	Principal Amount of Such Note E-
1	1	Oct. 1, 1963	$1,631.85	$ 65.28
2	2	" " 1964	1,631.86	65.27
3	3	" " 1965	1,631.85	65.28
4	4	" " 1966	1,631.86	65.27
5	5	" " 1967	1,631.85	65.28
6	6	" " 1968	1,631.86	65.27
7	7	" " 1969	1,631.85	65.28
8	8	" " 1970	1,631.86	65.27
9	9	" " 1971	1,631.85	65.28
10	10	" " 1972	1,631.86	65.27
11	11	" " 1973	3,566.11	143.45

The Company waives demand, notice of non-payment and protest and agrees that in case suit shall be brought for the collection hereof to pay reasonable attorneys' fees for making collection.

All notes of said series are alike except as to amount, designation and due date, except that those notes maturing October 1, 1963 and October 1, 1964 are not subordinated.

Upon the occurrence of any one or more of the following events, that is to say:

(a) In the event default shall be made in the due and punctual payment of any installment of interest on this Note, or any other note of this series, when and as the same shall become due and payable as therein expressed, and such default shall continue for a period of thirty (30) days; or

(b) In the event default shall be made in the due and punctual payment of the principal of any of the said Plantpat, Inc. 5½% Serial Notes (Subordinated) when and as the same shall become due and payable as therein provided and such default shall continue for a period of thirty (30) days; or

(c) In the event the Company shall become insolvent, or shall file a voluntary petition in bankruptcy, or shall be adjudicated a bankrupt, or shall make an as-

signment for the benefit of creditors, or shall otherwise acknowledge in writing its insolvency; or in the event any order, judgment or decree shall be entered by any court of competent jurisdiction appointing a receiver of the Company or of the whole or any substantial part of the properties of the Company, and such receiver shall not be removed or discharged within sixty days from the date of qualification of such receiver,

then and in any such event, the entire principal amount of all then outstanding and unpaid notes of this issue, together with all interest then accrued, shall be due and payable immediately upon the delivery to the Company, at its principal office in Birmingham, Alabama, of a notice in writing to such effect. The holder of any of said serial notes, anything herein contained to the contrary notwithstanding, by written notice to the Company, may waive the default by reason of which the principal of the note or accrued interest thereon, shall have become so due and payable, and the consequences of such default; but no such waiver shall extend to or affect any subsequent default or impair any right consequent thereon.

This note is issued pursuant to the terms of an agreement between the Company and the former stockholders of Plantation Patterns, Inc., dated September 28, 1962, pursuant to which such former stockholders (one of whom is the payee named above) made warranties to and agreements with the Company, as a result of which said Selling Stockholders may become indebted to the Company. The Company is hereby given the right to offset the amount of such debt (or any portion thereof) against the principal of this note. Any such offset may be effected by notification in accordance with the notification provisions of the said agreement, and shall be binding upon all holders hereof. A copy of said agreement is lodged at the offices of the Company.

The Company reserves the right to prepay this note (or any portion thereof in multiples of $1,000) at any time without prepayment penalty or premium.

Subject only to the provisions above, with respect to serial maturities, all notes of this issue rank equally and ratably without priority one over another.

IN WITNESS WHEREOF, the Company has caused this note to be executed and delivered this 28th day of September, 1962.

PLANTPAT, INC.
By JOHN S. JEMISON, JR.
Its Authorized Officer
(Seal)

In consideration of the credit extended at my request by the payee of this note in accepting it instead of cash and for other value received, I do hereby promise the holder of this note that the amount of this and all the other notes of which this is one of a series, together with the interest thereon, will be promptly paid when due. This obligation on my part shall be an unconditional general obligation and in no way subject to any subordination or other provision of said note and may be enforced against me separately without joining the maker in an action to collect it and without first taking any action against the maker to collect it. As against this obligation I waive all right of exemption and agree that in event of default in this obligation I will pay all costs of enforcing this obligation, including a reasonable attorney's fee.

JOHN S. JEMISON, JR.
John S. Jemison, Jr.

In consideration of the credit extended to the Company, by the payee of this note in accepting it instead of cash and for other value received, the undersigned does hereby promise the holder of this note that the amount of this and

all the other notes of which this is one of a series, together with interest thereon, will be promptly paid when due. This obligation on the part of the undersigned shall be an unconditional general obligation and in no way subject to any subordination or other provision of said note and may be enforced against the undersigned separately without joining the maker in an action to collect it and without first taking any action against the maker to collect it.

The undersigned agrees that in the event of default of this obligation, it will pay all costs of enforcing this obligation, including a reasonable attorney's fee.

JEMISON INVESTMENT CO., INC.
By JOHN S. JEMISON, JR.
Its Authorized Officer

APPENDIX IV

SUBORDINATION PROVISIONS CONTAINED IN THE 6½% DEBENTURES [PLANTPAT, INC. 6½% SERIAL DEBENTURE (SUBORDINATED)] ISSUED TO BRADFORD AND COMPANY, INC. (R. 269-70)

"The indebtedness evidenced by this debenture, and interest thereon, shall be at all times and in all respects wholly *Subordinate* and *Junior* to all other indebtedness of the Company, whether now owed or hereafter incurred, of whatever kind, class or type, herein called 'Superior Indebtedness'.

"Without limiting the effect of the foregoing, 'Subordinate' and 'Junior' as used herein shall be deemed also to mean that the indebtedness evidenced by this debenture, and interest thereon, shall, in the event of default in payment of the principal of any debenture of this issue or interest thereon, or in the event of default in the payment of the Superior Indebtedness, be entitled to payment only after there shall have first been paid all such 'Superior Indebtedness'.

"In the event of any distribution, division or application, partial or complete, voluntary or involuntary, by operation of law or otherwise, of all or any part of the assets of the Company, or the proceeds thereof, to creditors of the Company, or upon any indebtedness of the Company by reason of the liquidation, dissolution, or other winding up of the Company, or by reason of any execution, sale or receivership, insolvency or bankruptcy proceedings, or proceedings for the reorganization or readjustment of the Company or its property, then and in such event, any payment or distribution of any kind or character, either in cash, property or securities, which shall be made upon or in respect of this debenture or interest thereon, or any other debenture of this series, shall be paid over to the owners and holders of said 'Superior Indebtedness' in the proportion that the

principal amount of said 'Superior Indebtedness' of each owner and holder thereof bears to the whole amount of said 'Superior Indebtedness' then outstanding, for application in payment thereof, unless and until such 'Superior Indebtedness' shall have first been paid and satisfied in full.

"The Company covenants and agrees for the benefit of each and every holder of 'Superior Indebtedness' that if and when the maturity of any of the debentures of this issue shall be accelerated as hereinafter provided, upon occurrence of any one or more of the events of default as hereinafter defined, then each holder of any 'Superior Indebtedness' then outstanding shall have the right to declare immediately due and payable on demand all or any part of such 'Superior Indebtedness' owing and payable to such holder, regardless of any other maturities or terms of said 'Superior Indebtedness', and, if and when the maturity of this debenture, or any other debenture of this series, shall be accelerated or any notice of default under the terms of this debenture be served upon the Company, then and in that event, the Company shall agree and agrees that it will immediately notify the holders of 'Superior Indebtedness' of such acceleration or default, as the case may be.

"No right of any present or future holder of any 'Superior Indebtedness' of the Company to enforce subordination as herein provided, shall at any time in any way be prejudiced or impaired, by any act or failure to act on the part of the Company or by any act or failure to act in good faith, by any such holder, or by any non-compliance by the Company with the terms, provisions and covenants of this debenture, regardless of any knowledge thereof any such holder may have or be otherwise charged with."

APPENDIX V

The indebtedness evidenced by this note shall be at all times and in all respects wholly *Subordinate* and *Junior* to all other indebtedness of the Company, whether now owed or hereafter incurred (except the $150,000 indebtedness owed the Company represented by its 6½% Serial Debentures (Subordinated) dated this date, which shall be subordinated to this series), herein called "Superior Indebtedness".

Without limiting the effect of the foregoing, "Subordinate" and "Junior" as used herein shall be deemed also to mean that the indebtedness evidenced by this Note shall, in the event of default in payment of the principal of any note of this issue or interest thereon, or in the event of default in the payment of the Superior Indebtedness, be entitled to payment only after there shall have first been paid all such "Superior Indebtedness".

In the event of any distribution, division or application, partial or complete, voluntary or involuntary, by operation of law or otherwise, of all or any part of the assets of the Company, or the proceeds thereof, to creditors of the Company, or upon any indebtedness of the Company by reason of the liquidation, dissolution, or other winding up of the Company, or by reason of any execution, sale or receivership, insolvency or bankruptcy proceedings, or proceedings for the reorganization or readjustment of the Company or its property, then and in such event, any payment or distribution of any kind or character, either in cash, property or securities, which shall be made upon or in respect of this Note or interest thereon, or any other note of this series, shall be paid over to the owners and holders of said "Superior Indebtedness" in the proportion that the principal amount of said "Superior Indebtedness" of each owner and holder thereof bears to the whole amount of said "Superior Indebtedness" then outstanding, for application in payment thereof, unless and until such

"Superior Indebtedness" shall have first been paid and satisfied in full.

The Company covenants and agrees for the benefit of each and every holder of "Superior Indebtedness" that if and when the maturity of any of the Notes of this issue shall be accelerated as hereinafter provided, upon occurrence of any one or more of the events of default as hereinafter defined, then each holder of any "Superior Indebtedness" then outstanding shall have the right to declare immediately due and payable on demand all or any part of such "Superior Indebtedness" owing and payable to such holder, regardless of any other maturities or terms of said "Superior Indebtedness", and, if and when the maturity of this note, or any other note of this series, shall be accelerated or any notice of default under the terms of this note be served upon the Company, then and in that event, the Company shall agree and agrees that it will immediately notify the holders of "Superior Indebtedness" of such acceleration or default, as the case may be.

No right of any present or future holder of any "Superior Indebtedness" of the Company to enforce subordination as herein provided, shall at any time in any way be prejudiced or impaired, by any act or failure to act on the part of the Company or by any act or failure to act in good faith, by any such holder, or by any non-compliance by the Company with the terms, provisions and covenants of this Note, regardless of any knowledge thereof any such holder may have or be otherwise charged with.

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IN THE

Supreme Court of the United States

October Term, 1972

No. 72-523

PLANTATION PATTERNS, INCORPORATED,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

JOHN S. JEMISON, JR. and MARIE S. JEMISON,
Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

BRIEF OF *AMICUS CURIAE* IN SUPPORT OF PETITION

RALPH J. GREGG,
Amicus Curiae,
2110 Main Place Tower,
Buffalo, New York 14202.

BATAVIA TIMES, LAW PRINTERS,
BATAVIA, N. Y.

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BRIEF OF *AMICUS CURIAE* IN SUPPORT OF PETITION

Reasons for Submission of *Amicus* Brief

The writer of this brief is a stranger to the taxpayers-petitioners and their attorneys.

The reason for his concern is that the basic form of the transaction by which Plantation Patterns, Inc. (New)

acquired the assets and business of Plantation Patterns, Inc. (Old) is the same that has been used at least 100,000 times by other buyers and sellers in the past 25 years and is still being used every day in the week as a perfectly proper, legal and businesslike method of financing the purchase of a going business.

The Fifth Circuit has completely misconstrued a simple, ordinary, garden-variety business deal, understood by all of the parties to be a corporate transaction, as being a somehow disguised acquisition by Mr. Jemison as an individual. The result is that the corporation is taxed with the actual income and Mr. Jemison with "imagined" income. This is double taxation of the most vicious type.

The reaction of professional people is one of shocked disbelief. They know this case will create needless havoc in the field of corporate law and finance unless a writ is granted and the decision is reversed.

ARGUMENT

I. Illustration showing it would be impossible for an individual (like Jemison) to borrow $500,000.00 to purchase the stock of a corporation (as the Fifth Circuit claims he did).

The best way to explain the real issue is to illustrate what actually happens in this type of transaction. The parallel will be obvious.

Our client has an opportunity to purchase the stock of a corporation producing a net annual income, after salaries, of $140,000.00 for the sum of $600,000.00. The most he can raise is $100,000.00 of which $80,000.00 will have been borrowed from his father on "slow" notes which will be

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subordinate to any other financing. He will have to borrow $500,000.00 from a bank or give the sellers $500,000.00 in promissory notes payable over a ten-year period at the rate of $50,000.00 a year, with interest.

We tell our client there is no way he can possibly acquire the corporation as an individual. In order to have $50,000.00 left after taxes to pay just the principal on the notes (in addition to his living expenses from the after-tax income on his $40,000.00 salary)—$90,000.00 in all—he will have to have an income of $250,000.00, as follows:

Taxable income	$250,000.00
Less: Tax on $250,000.00 (Per Table)	158,090.00*
Left for note payment and living expense	$ 91,910.00

As a matter of fact, he would need a gross income of $280,000.00 the first year to pay the $30,000.00 of interest on the notes as an additional outlay. There would be no way he could possibly get $280,000.00 out of a corporation earning only $140,000.00 before taxes.

The utter futility of any attempt to pay a $500,000.00 debt out of dollars subject to tax on an individual return has been an accepted fact of business life ever since the government started taking the lion's share of a business-man's personal income.

* See Appendix.

TOO CLOSE IN CENTER

II. Typical plan of acquisition (used by tens of thousands of Jemisons).

We advise him to form a new corporation to be the purchaser of the stock. Then, by merger, his new corporation will *acquire all the assets* of the subsidiary *and become the owner of the income* out of which the annual payments are to be made. The debt will now be manageable. His corporation will pay $47,300.00 in taxes (only $110,000.00 subject to tax after the interest deduction). It will have $92,700.00 left with which to pay the $80,000.00 of principal and interest due on the notes. It will also have the combined assets to use as collateral security. Only a corporation can salvage enough out of $140,000.00 of taxable income to repay a $500,000.00 loan.

The seller understands he is dealing with a new corporation as the purchaser. Sometimes the seller asks for and gets a collateral mortgage lien on the real property and security interests in the machinery, equipment, inventories, etc. acquired by the new corporation as a result of the merger. Sometimes the new corporation purchases the assets instead of the stock and they are used as collateral. More often than not, the seller demands that the notes be personally guaranteed by the stockholder of the new corporation.[1]

Year in and year out this has been an orthodox routine method of acquiring a business on credit. In a typical transaction the seller (or banker) relies first on the ability of the business to generate enough income to pay the notes, secondly on the value of the underlying assets and, lastly, on the personal assets of the guarantor.

---

[1] It makes no difference if the credit is extended by a bank or by the seller. The request for the personal guarantee of the stockholder is difficult to refuse.

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III. The Fifth Circuit's version of this is unreal.

But, says the Fifth Circuit, *this was not the real substance* of the transaction. Even though the seller, in an arms-length transaction, accepted the promissory notes of the new corporation, he was really making a personal loan to your client. Your client, though only guaranteeing the notes, became the actual borrower of the $500,000.00 and contributed it to the capital of the corporation.

Therefore, any payments of principal or interest made by the corporation to the seller were in discharge of your client's personal debt and taxable to him as "constructive dividends".[2]

The amazing result of the Court of Appeals decision is to generate $250,000.00 of taxable income and $93,500.00 of taxes out of a fact situation where there was only $140,000.00 of taxable cash income to begin with. This is shown below:

---

[2] Clearly in conflict with *Holsey v. Commissioner,* 258 F. 2d 865 (CCA-3) (1958) which holds that payments which discharge a corporate debt are not constructive dividends to a stockholder who benefits only indirectly. Mr. Jemison's exposure was lessened by every payment made on the corporate debt. He was not liable except in the event of a default. The benefit was indirect.

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	Taxable Income	*Tax*
Net income of corporation after salaries	$140,000	$
Less: Interest deduction	30,000	
	$110,000	
Tax at 48%, less surtax exemption on $110,000		47,300
THE FIFTH CIRCUIT ADDS:		
Additional income to corporation because of disallowance of deduction for 6% interest paid by the corporation to seller on $500,000	30,000	
Tax at 48%		14,400
Additional income to our client based on theory the principal and interest paid to the seller were constructive dividends to him	80,000	
Additional tax to him on $50,000 of imaginary income ($80,000 less $30,000 interest deduction)		31,800
Actual $140,000 of income has now become	$250,000	
Total tax on $140,000 has now become		$93,500

The decision arbitrarily and artificially reverses the substance of a genuine, arms-length transaction. The result is horrible for both our client and his corporation because:

(1) Now, the corporation is unable to repay the loan. The government is collecting $61,700.00 from it in taxes, leaving it with only $78,300.00 to service its debt.

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(2) Our client is ruined financially and for life. His only income consists of his take-home pay from his $40,000.00 salary (about $25,610.00). But the Fifth Circuit would say he must pay a $31,800.00 tax deficiency. He will spend the rest of his life in bondage. There is no way he can discharge a tax debt in bankruptcy.

This is what the Fifth Circuit decision would do to the Jemisons in the business community. The real Mr. Jemison may be able to survive it because of his other resources. But 90% of the clients who, because of their limited assets and need for credit, use a new corporation to acquire ownership of another corporation could not.

IV. Plantation Patterns contains at least six major misconceptions of both fact and law.

The basic facts in Plantation Patterns, Inc. are obscured by rhetoric and tortuous theorizing about matters that are not a bit germane to the problem. There are no fewer than six major misconceptions as follows:

(1) The "thin corporation" theory[3] does not apply to the facts of the case. It applies only when (a) a *stockholder* claims that payments made to *him* were in repayment of a genuine loan, or (b) a corporation claims that the interest it paid to a *stockholder* was a legitimate interest deduction. The Jemisons were the stockholders. Plantation Patterns, Inc. paid nothing to them and claimed no deductions for any amounts paid to them. All payments were made to *creditors*.

[3] This theory serves a useful purpose in preventing a stockholder from getting dividends out of his corporation disguised as interest or as a return of capital. It was not intended to prevent creditors from being paid their just debts.

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(2) The ratio of debt to equity is not germane to either the facts or the issues. It applies only when a stockholder supplies both. It does not apply when a stockholder supplies the loan.[4] Debt to creditors can never be equity in any sense of the word.

(3) The Court assumes that Plantation (New) had nothing but a $5,000.00 capital investment and Mr. Jemison's guarantee to support a $759,000.00 debt. It lost complete sight of the fact that, when the transaction was closed, Plantation (New) acquired, by merger, all of the assets of Plantation (Old). The surviving corporation was completely solvent and the combined assets were completely adequate to support the debt as is shown in the Court's own footnote.

(4) The fact that some notes to *creditors* are subordinate to other notes to *creditors* is a wholly improper criterion for determining that some of them are debt and some are equity. They could never be equity, no matter how subordinate, any more than a second or third mortgage loses its identity as a debt by being subordinate to the first or second mortgage.

(5) By attaching special significance to Mr. Jemison's guarantee and none to the guarantee of the $11,000,000.00 Jemison Investment Company, Inc., the Court of Appeals made strange new law. It said, in effect, that a *person* who guarantees a note becomes the real debtor, the "primary obligor" no less; but that a corporate guarantor remains only a guarantor. The Court is saying, in substance, that any stockholder who personally guarantees the loans of a corporation is taxable on his share of the income of the corporation used to repay its debts. It would be a sad day for the American economy if this were true.

---

[4] The ratio of debt supplied by creditors to equity supplied by a stockholder is an arms-length transaction. There is no self dealing for the Court to be concerned with.

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(6) Perhaps the most glaring misconception was the Court's insistence that the wherewithal to pay the debt be found only on the balance sheet. The Court looked every place except the right one—the profit and loss statement.

The table set forth below shows the earnings available for the three-year period immediately following the acquisition, and the amount actually required:

Year	Net Income After Taxes	Interest Deduction On Notes and Debentures	Depreciation Deduction	Amount Available For Debt Services	Amount Required For Debt Service
1963	$73,938	$43,293	$55,763	$172,994	$93,293
1964	99,467	40,593	63,069	203,129	90,593
1965	57,574	37,756	68,937	164,267	87,756

This was the real substance of the transaction. It was only by ignoring the most important evidence in the case—the statements of profit and loss—that the Court was able to come to the inane conclusion that there was no reasonable expectation that the new corporation could succeed on its own and that no significance could be attached to the fact that it did.

V. Plantation Patterns is in fundamental conflict with the basic principles of corporate law and finance.

Plantation Patterns, Inc. has been forced into a search for conflict in the Circuit Courts to merit the attention of the Supreme Court. It has done this admirably. The Fifth Circuit's opinion is in fundamental conflict with almost every well reasoned judicial decision on the subject.[5] It is also in fundamental conflict with basic business prin-

[5] *Murphy Logging Co. v. U. S.*, 378 F. 2d 222 (CCA-9); *Arthur J. Kobacker*, 37 T. C. 882; *Kraft Foods Co. v. CIR*, 232 F. 2d 118 (CCA-2); *In re Credit Industrial Corp.*, 336 F. 2d 402 (CCA-2); *United States v. Key*, 397 U. S. 322; *U. S. v. Cumberland Public Service*, 338 U. S. 451, among many others.

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ciples as they are understood and practiced in the financial community.

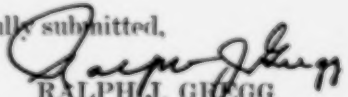
The decision has significance far beyond its effect on Mr. Jemison's pocketbook. Already many corporate lawyers are discouraging their clients from any deals where they are asked to personally guarantee corporate debts because they are concerned about the threat of confiscatory double taxation under the "constructive dividend" theory.

On the other hand, many banks and sellers insist on the traditional personal guarantee. They are not a bit concerned about the buyer's tax problems and scoff at the lawyers fears of constructive dividends. Hence, a stalemate in many thousands of business transactions that should, after all these years, be governed by a rule of law that is logical and certain.

Conclusion

A writ of certiorari should be granted.

Respectfully submitted,



RALPH J. GREGG,
Amicus Curiae,
2110 Main Place Tower,
Buffalo, New York 14202

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APPENDIX

Page 22
1971 Tax Rate
Schedules

If you do not use one of the Tax Tables, figure your tax on the amount

SCHEDULE X—Single Taxpayers Not Qualifying for Rates in Schedule Y or Z

If the amount on Form 1040, line 50, is:		Enter on Form 1040, line 19:	
Not over $500		14% of the amount on line 50.	
Over—	*But not over—*		*of excess over—*
$500	$1,000	$70+15%	$500
$1,000	$1,500	$145+16%	$1,000
$1,500	$2,000	$225+17%	$1,500
$2,000	$4,000	$310+19%	$2,000
$4,000	$5,000	$690+21%	$4,000
$5,000	$8,000	$1,110+24%	$6,000
$8,000	$10,000	$1,590+25%	$8,000
$10,000	$12,000	$2,090+27%	$10,000
$12,000	$14,000	$2,630+29%	$12,000
$14,000	$16,000	$3,210+31%	$14,000
$16,000	$18,000	$3,330+34%	$16,000
$18,000	$20,000	$4,510+36%	$18,000
$20,000	$22,000	$5,230+38%	$20,000
$22,000	$26,000	$5,990+40%	$22,000
$26,000	$32,000	$7,590+45%	$26,000
$32,000	$38,000	$10,290+50%	$32,000
$38,000	$44,000	$13,290+55%	$38,000
$44,000	$50,000	$16,590+60%	$44,000
$50,000	$60,000	$20,190+62%	$50,000
$60,000	$70,000	$25,390+64%	$60,000
$70,000	$80,000	$32,790+66%	$70,000
$80,000	$90,000	$39,390+68%	$80,000
$90,000	$100,000	$46,190+69%	$90,000
$100,000	. . .	$53,090+70%	$100,000
$100,000		= 53,090	
150,000	× 70%	=105,000	
250,000		158,090	

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Appendix

SCHEDULE Y—Married Taxpayers and
if you are a married person living apart from
in this package to see if you can be consi
using Schedule X or Z.

Married Taxpayers Filing Joint Returns and Certain Widows and Widowers (see page 4)

If the amount on Form 1040, line 50, is:		Enter on Form 1040, line 19:	
Not over $1,000		14% of the amount on line 50.	
Over—	*But not over—*		*of excess over—*
$1,000	$2,000	$140+15%	$1,000
$2,000	$3,000	$290+16%	$2,000
$3,000	$4,000	$450+17%	$3,000
$4,000	$8,000	$620+19%	$4,000
$8,000	$12,000	$1,380+22%	$8,000
$12,000	$16,000	$2,260+25%	$12,000
$16,000	$20,000	$3,260+28%	$16,000
$20,000	$24,000	$4,380+32%	$20,000
$24,000	$28,000	$5,660+36%	$24,000
$28,000	$32,000	$7,100+39%	$28,000
$32,000	$36,000	$8,660+42%	$32,000
$36,000	$40,000	$10,340+45%	$36,000
$40,000	$44,000	$12,140+48%	$40,000
$44,000	$52,000	$14,060+50%	$44,000
$52,000	$64,000	$18,060+53%	$52,000
$64,000	$76,000	$24,420+55%	$64,000
$76,000	$88,000	$31,020+58%	$76,000
$88,000	$100,000	$37,980+60%	$88,000
$100,000	$120,000	$45,180+62%	$100,000
$120,000	$140,000	$57,580+64%	$120,000
$140,000	$160,000	$70,380+66%	$140,000
$160,000	$180,000	$83,580+68%	$160,000
$180,000	$200,000	$97,180+69%	$180,000
$200,000	. . .	$110,980+70%	$200,000

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489-353—72——1

In the Supreme Court of the United States

OCTOBER TERM, 1972

No. 72-523

PLANTATION PATTERNS, INCORPORATED, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

JOHN S. JEMISON, JR. AND MARIE S. JEMISON, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The memorandum opinion of the Tax Court (¶ 70,182 P-H Memo TC) is not reported. The opinion of the court of appeals (Pet. App 2a-24a) is reported at 462 F. 2d 712.

JURISDICTION

The judgment of the court of appeals was entered on June 15, 1972. (Pet. App. 1a.) A petition for rehearing was denied on July 6, 1972. (Pet. App. 2a.) The petition for a writ of certiorari was filed on September 30, 1972. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether the courts below were correct in holding that, under the circumstances of this case, the application of the corporate petitioner's earnings to the discharge of an obligation guaranteed by its sole shareholder, one of the individual petitioners, constituted a dividend taxable to the individual petitioners under Sections 301 and 316 of the Internal Revenue Code of 1954, and gave rise to no interest deduction for the corporate petitioner under Section 163(a).

STATUTES INVOLVED

The pertinent provisions of Sections 163, 301, 302, and 316 of the Internal Revenue Code of 1954 are set forth in the Appendix to the Petition. (Pet. App. 25a–26a.)

STATEMENT

The corporate petitioner, Plantation Patterns, Inc. ("New Plantation") was organized by the individual petitioners in 1962 under the laws of Alabama to acquire and operate a wrought iron furniture business then and previously operated by another Alabama corporation of the same name ("Old Plantation"). (Pet. App. 5a–6a.) The somewhat intricate arrange-

ments for the transfer and for the payment of the purchase price have given rise to this litigation in which the Commissioner of Internal Revenue asserted, and the courts below held, that the corporate petitioner's payments on the purchase price constituted dividends taxable to its sole shareholders, the individual petitioners. The transaction giving rise to the controversy, as largely stipulated, and as found by the courts below, was as follows:

During several years prior to 1962, Old Plantation was engaged in the manufacture and sale of wrought iron furniture in Birmingham, Alabama, and in the manufacture and sale of metal office chairs at Leeds, Alabama. Its stock was owned by five shareholders, two of whom, Thomas E. Jernigan and William C. Jernigan, owned an aggregate of 243,201 of the 270,000 shares outstanding, and were the principal officers of the corporation. Following the abandonment of plans for a public offering of stock in order to raise needed capital, the Messrs. Jernigan decided that it would be wise to sell the wrought iron furniture business and to develop the metal chair business. During the summer of 1962 the five shareholders of Old Plantation decided as a group to sell their Old Plantation stock. (Pet. App. 3a–4a.)

During the summer of 1962, inquiry was made of the petitioner, John S. Jemison, Jr., whether he would be interested in purchasing or finding a purchaser for the Old Plantation stock. Mr. Jemison was an investment banker of some twenty years' experience. He was the president and sole stockholder of Jemison

Investment Company, Inc., a corporation with assets of eleven million dollars that included such varied enterprises as subsidiaries engaged in public transportation, in manufacturing, and in the operation of department stores in Florida and Alabama. He had arranged for the acquisition of businesses both for clients of the Investment Company and for its own account, both as purchases of assets and as purchases of stock. (Pet. App. 4a–5a.)

In August, 1962, Mr. Jemison wrote to Mr. Thomas Jernigan making a conditional offer to purchase the "assets of the Plantation Patterns Division." The letter set forth a plan for forming a new corporation to effectuate the purchase, a corporation that would have capital of $5,000 in common stock and would borrow $150,000 on notes to be subordinated to a purchase money obligation running to the seller of the wrought iron furniture assets. (Pet. App. 5a.)

The stockholders of Old Plantation made an independent investigation of Mr. Jemison's credit, and then accepted, with modifications, the proposal made by Mr. Jemison. The modified agreement called for New Plantation, the corporation to be organized, to purchase the stock of Old Plantation for a stated price equal to the net worth of Old Plantation plus $644,909.53, or a total of $893,314.17. The agreement contemplated that New Plantation would liquidate Old Plantation upon acquisition of its stock, and would then sell to Messrs. Thomas and William Jernigan the assets of the metal chair division for $183,-

435.84, their book value. The purchase price for the Old Plantation stock was to be paid as follows:

(1) A cash payment of $100,000 at the time of closing;

(2) An amount equal to the book value of the metal chair division ($183,435.84) payable without interest in installments in January, March, and June, 1963;

(3) The balance ($609,878.33) in equal installments of $50,000 beginning October 1, 1963, and annually thereafter, with a final installment of $109,878.33 due on October 1, 1973. Notes representing these installments were to be guaranteed by the Jemison Investment Company, and by Mr. Jemison personally. (Pet. App. 7a.)

An agreement embodying these terms was executed on September 28, 1962, with New Plantation and the stockholders of Old Plantation as signatories. Mr. Jemison had caused New Plantation to be organized on September 25, 1962. Its capital of $5,000 was paid in by check of petitioner Marie S. Jemison, Mr. Jemison's wife, and fifty shares of common stock were issued in her name. Mrs. Jemison, though named a director, was not active in the affairs of New Plantation, and she held the stock only by arrangement of Mr. Jemison, as the Tax Court found. (Pet. App. 6a–7a.)

On September 27, 1962, New Plantation obtained $150,000 by loan from Bradford and Company, Inc., an unrelated investment company, for which it issued 6½ percent debentures maturing serially from 1974 to 1976. These debentures were subordinated to all other indebtedness of New Plantation. Bradford and

Company was controlled by Mr. Thomas Bradford, and the loan was made as an inducement to Mr. Jemison to place Mr. Bradford's son with New Plantation. (Pet. App. 6a–7a.)

Upon execution of the agreement between New Plantation and the stockholders of Old Plantation on September 28, 1962, the latter transferred their stock to New Plantation, which promptly liquidated Old Plantation. By another agreement executed the same day, New Plantation agreed to sell the metal chair assets to Messrs. Thomas and William Jernigan for $183,435.84, their book value to Old Plantation, payable without interest in 1963. These assets were promptly transferred, and as a result the Messrs. Jernigan acquired the metal chair assets through an exchange or offset of notes. (Pet. App. 8a–9a.)

On its part, New Plantation, upon execution of the agreement of September 28, 1962, paid the stockholders of Old Plantation $100,000 cash, delivered the non-interest bearing notes for $183,435.84 (later offset or exchanged for the obligations of the Messrs. Jernigan in payment for the metal chair assets), and delivered its 5½ percent notes maturing serially from October 1, 1963 through October 1, 1973. These last notes were guaranteed absolutely as to principal and interest by Mr. Jemison and by the Jemison Investment Company. The Investment Company received a fee of $15,000 annually for its guarantee, but Mr. Jemison received no fee for his guarantee. As the agreement contemplated, these notes, aggregating $609,878.33 in face amount, were, except for $50,000 payable in October,

1963, and $50,000 payable in October, 1964, subordinated to all other indebtedness of New Plantation except the Bradford loan. The notes aggregating $100,000 payable in 1963 and 1964 were not subordinated so that Mr. Jemison could arrange for the holders to discount them at a bank. Like the subordinated notes, they were covered by the guarantees of Mr. Jemison and the Jemison Investment Company. (Pet. App. 8a.)

During the taxable period from October 1, 1962, through September 30, 1966, New Plantation paid principal and interest due on the 5½ percent notes issued to the former stockholders of Old Plantation. It also paid the interest on the 6½ percent debentures issued to the Bradford Investment Company. On its returns for the taxable years ending September 30, 1963, through September 30, 1966, New Plantation accrued and deducted $117,652.65 interest paid on the 5½ percent notes issued to the former stockholders of Old Plantation, as well as the interest on the Bradford loan. (Pet. App. 10a.)

The Commissioner of Internal Revenue disallowed the interest deductions taken with respect to the 5½ percent notes issued to the former stockholders of Old Plantation, and asserted against New Plantation the deficiencies here in issue with respect to it. (Pet. App. 10a.) The Commissioner also asserted against the individual petitioners, Mr. and Mrs. Jemison, a deficiency for the calendar year 1963, asserting that the payments of principal and interest made by New Plantation in that year on the notes issued to the

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former stockholders of Old Plantation constituted dividends to the individual petitioners paid by New Plantation. (Pet. App. 11a.)

The Tax Court found that the assets of New Plantation were wholly inadequate to support a debt of $609,878.33, and that no source would have advanced $600,000 in money or property to New Plantation without the guarantee of Mr. Jemison, who, by virtue of that guarantee, acquired the beneficial interest in the business and assets transferred to New Plantation. Employing familiar debt-equity criteria with respect to the corporation's notes as well as the fact that the stockholders of Old Plantation relied upon Mr. Jemison's credit, the Tax Court concluded that the obligations in form guaranteed by Mr. Jemison should be recognized as primarily his. It therefore treated the payments of principal and interest made by New Plantation as payments upon the obligation of its shareholder, and therefore as taxable dividends. Consequently, it upheld the deficiencies against the corporate petitioner asserted by the Commissioner, and largely upheld the deficiency asserted against the individual petitioners, modifying the latter only to the extent of holding that insofar as the individual petitioners received dividends by virtue of payments on the interest obligation, they should be allowed an offsetting deduction for interest paid.

The court of appeals, after fully reviewing the Tax Court's analysis and conclusions, affirmed its decisions, concluding that "None of the Tax Court's Findings and Conclusions based upon stipulated facts are shown to be 'clearly erroneous.'" (Pet. App. 24a.)

ARGUMENT

The decision below is correct. There is no conflict of decisions, no question of general importance is involved, and there is no other apparent reason for review by this Court.

This case presents one of a number of procedural variants upon a familiar transactional pattern. The prototype transaction is one in which individuals acquire the beneficial interest in the stock or assets of a going business by having the stock or assets transferred to a controlled corporation, frequently organized for that purpose. The individuals thus gaining beneficial ownership of the enterprise are liable for the purchase price, and subsequently have their obligation discharged by payments from the earnings of the controlled corporation. Though the procedural variations upon this transactional structure are numerous, and often complex, the decisions are consistent in holding that the controlled corporation's discharge of its shareholders' obligation constitutes a dividend taxable to the shareholders, as the Commissioner asserted, and the courts below held, in this case. See, *e.g.*, *Wall* v. *United States*, 164 F. 2d 462 (C.A. 4); *Woodworth* v. *Commissioner*, 218 F. 2d 719 (C.A. 6); *Ferro* v. *Commissioner*, 242 F. 2d 838 (C.A. 3); *Zipp* v. *Commissioner*, 259 F. 2d 119 (C.A. 6); *Schalk Chemical Company* v. *Commissioner*, 304 F. 2d 48 (C.A. 9); *Idol* v. *Commissioner*, 319 F. 2d 647 (C.A. 8); *Maher* v. *Commissioner*, 72-2 U.S.T.C. par. 9728 (C.A. 8); *Deutsch* v. *Commissioner*, 38 T.C. 118.

The variation employed in this case was that the acquiring individual's liability for the purchase price

was in the form of Mr. Jemison's guarantee of the largely subordinated obligations issued by the corporation, New Plantation. Cf. *Deutsch* v. *Commissioner, supra.* Under the circumstances of this case, the courts below properly held that that variation was without significance. On a purely factual basis, they noted that the sellers had made an independent investigation of Mr. Jemison's credit. That that was the element upon which the sellers relied was indicated by the fact that the notes executed by New Plantation were not secured other than by the guarantees[1] given and by the fact that the notes of New Plantation were largely subordinated to other indebtedness of the corporation—rarely a characteristic of purchase money obligations.

Beyond these purely factual elements, which would alone support, if they did not require, the conclusion that Mr. Jemison's guarantee was the primary obligation to which the sellers looked, the courts below employed familiar debt-equity criteria[2] in appraising

[1] The guarantee of Jemison Investment Company supplemented Mr. Jemison's guarantee by giving the sellers a direct claim against Mr. Jemison's principal asset.

[2] As the opinion of the court of appeals indicates (Pet. App. 13a–14a), the problem of debt-equity classification arises frequently, and in a number of contexts. The extensive catalog of factors that may appear relevant in one context or another has called for a case-by-case analysis and appraisal. In Section 415 of the Tax Reform Act of 1969, P.L. 91–172, 83 Stat. 613, adding Section 385 to the Internal Revenue Code of 1954, the Congress for the first time dealt with the problem by authorizing regulations specifically addressed to the question and by supplying a non-exclusive list of factors to be taken into account. The Senate Finance Committee, which proposed the

the status of the corporate obligation. They concurred in concluding that the corporate obligation was not such as would have been relied upon by a creditor to extend credit in an amount exceeding $600,000 to New Plantation. The concurring judgment of two courts upon the complex facts of a particular case does not call for review by this Court.

From the conclusion of the courts below that Mr. Jemison's guarantee was the primary obligation whereby he acquired beneficial ownership of the wrought iron furniture business operated by New Plantation, it follows that the decision that corporate payments on that obligation constituted dividends by the corporation, taxable to Mr. Jemison, was correct.

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amendment, described the problem in part as follows (S. Rep. No. 91-552, 91st Cong., 1st Sess., p. 137):

> *General reasons for change.*—It is a difficult task to draw an appropriate distinction between dividends and interest, or equity and debt. Even though a corporate obligation is labeled debt, it may be treated for tax purposes as equity, the payments on which accordingly are non-deductible dividends, if, in fact, the obligation represents an equity interest in the corporation. Some of the factors which may lead to the classification of a "debt obligation" of a corporation as equity include whether or not the bond or debenture is subordinated to the corporation's other creditors, whether or not the bond or debenture is convertible into stock of the corporation, and whether the corporation's debt-equity structure is such that it is reasonble to expect that it will be able to meet its obligations to pay the principal and interest on the bond or debenture when due.
>
> Although the problem of distinguishing debt from equity is a long-standing one in the tax laws, it has become even more significant in recent years because of the increased level of corporate merger activities and the increasing use of debt for corporate acquisition purposes.

That decision does not conflict with the decision of the Court of Appeals for the Ninth Circuit in *Murphy Logging Co.* v. *United States*, 378 F. 2d 222, where, on quite different facts, the court found the corporate purchaser of assets from a predecessor partnership financially able to sustain its obligations, and therefore relegated the stockholders' guarantee of a bank loan to secondary significance. That the two courts attributed somewhat different significance to the established earning power of Murphy Logging Company and the prospective earning power of New Plantation is not a conflict calling for review by this Court.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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